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THE ECONOMIC OUTLOOK

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before the

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CONGRESS OF THE UNITED STATES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

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THE ECONOMIC OUTLOOK

Wednesday, July 17, 2002

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

The Committee met, pursuant to notice, at 10:05 a.m., in Room 2226, Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Ryan, Dunn, English, Putnam and Hill; Senators Reed and Bennett.

Staff Present: Chris Frenze, Robert Keleher, Colleen Healy, Darryl Evans, Brian Higginbotham, Donald Marron, Patricia Ruggles, Chad Stone, Matthew Salomon, and Diane Rogers.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning. It is a pleasure to welcome Chairman Hubbard this morning to the Joint Economic Committee (JEC) to testify on the economic outlook.

The economy continues to rebound from the slowdown that began in the middle of 2000, eventually becoming a recession. In March of 2000, the NASDAQ began a sharp decline, with spreading weakness signaled later in that year by falling factory employment and industrial production. The slowdown became a mild recession in 2001, but economic indicators suggest that a recovery was under way by late last year.

Real GDP (gross domestic product) increased 6.1 percent in the first quarter of 2002, manufacturing activity rebounded, industrial production rose, and consumption and residential real estate remained strong. However, there are signs that the pace of economic expansion has moderated more recently.

The payroll employment data indicate that many employers have held off on new hiring until the stability of the recovery becomes clear. As a result, the output of goods and services is rising, but at a faster pace than is employment. Consequently, labor productivity in the first quarter surged, and is expected to remain strong in the second quarter.

The pace of the expansion may be affected by concerns about international tensions, terrorism, and corporate accounting practices. As a result, the level of risk and uncertainty is significant, and this imposes additional costs on the economy and also is reflected in the weak stock market.

As Chairman Greenspan pointed out just yesterday, our free market economic system is based on property rights, and fraud and deception are thefts of property. Reforms are needed in accounting and corporate governance to strengthen safeguards against those who would otherwise abuse the rights of shareholders. The President and Congress are moving forward to provide these needed reforms.

However, despite these problems, the remarkable resilience of the American people and economy continues to be evident. It appears likely that business profits and investment will recover in due course, consolidating and extending the U.S. economic expansion. The Federal Reserve's actions to reduce interest rates, and congressional actions to reduce the tax burden have improved the prospects of economic expansion.

Let me yield at this time to Senator Reed for any opening statement he may wish to make.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 31.]

PREPARED STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

Senator Reed. Thank you very much, Mr. Chairman.

I want to welcome Chairman Hubbard. He plays a critical role as Chairman of the Council of Economic Advisers (CEA). I am looking forward to hearing Chairman Hubbard's views on the state of the economy, and I wouldn't be surprised if we have some spirited discussion about the administration's latest forecast and its implications for budget and tax policy.

I have serious concerns about the economic policies that this administration is pursuing. We are very fortunate that the worst fears about how September 11th would affect the economy were not realized, but I fear that we may be experiencing the same kind of jobless recovery that we saw the last time around. When the recession ended in March of 1991, unemployment kept rising until July of 1992, and the Federal budget reached a record deficit of $290 billion. Last month the unemployment rate bumped up to 5.9 percent, and the number of unemployed people was nearly 2.4 million higher than it was when the recession started. Even though there was a small increase last month, the number of payroll jobs is lower now than it was at the beginning of the year. And, of course, every time we reestimate the budget deficit, it gets worse.

The administration seems to believe that more tax cuts are the answer. But how do budget-draining tax cuts skewed towards upper-income taxpayers address the concerns of ordinary Americans? People are worried about their jobs and their pensions; they want to be sure that Social Security is on a sound footing and that they can afford prescription drugs; they want to be assured that corporate executives are honest or that they will be caught and punished if they are not; and they want to believe that the government is on their side, working to help them improve their lives.

On another matter, I would like to commend the CEA on its role in improving the quality of Federal statistics. The proposal the administration unveiled last week to enhance data sharing among the Census Bureau, the Bureau of Labor Statistics, and the Bureau of Economic Analysis is an important step towards improving our ability to

measure and understand the rapidly changing economy. The JEC, too, has had a long tradition of working to improve the quality of Federal statistics. In fact, we are having a hearing next week on the topic of measuring economic change, and I look forward to working with the CEA on efforts to create a 21st century statistical infrastructure appropriate for a 21st century economy.

Dr. Hubbard, I look forward to hearing what you have to say about the economic outlook. I hope that the CEA is taking a hard look at economic realities and can give us some constructive advice on how we can improve the employment picture while stimulating economic growth and avoiding a new round of ballooning deficits. Thank you.

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 32.]

Representative Saxton. Thank you, Senator Reed.

Chairman Hubbard, thank you for being here this morning. We appreciate your participation.

Let me just announce at the outset that both the House and the Senate are expected to have votes in approximately 20 minutes. So we will get started, and unfortunately we will have a little interruption, and then we will come back to hear the rest of your testimony.

So, sir, if you would like to go lead and share your thoughts with us at this time, we would appreciate it.

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

Dr. Hubbard. Sure. Thank you very much, Mr. Chairman and Senator Reed and Congressman Ryan. I will be brief, because you have my full testimony.

What I really wanted to bring up for your attention were three things: One, to talk a little bit about the mechanics of the recovery that we are now seeing; second, to talk about what both of you raised in your opening statements, risks to the recovery; and, third, what kinds of public policies promote the recovery, and, frankly, what kinds of public policies might hinder it.

Our economic outlook at the administration, of course, has just been updated and released in the midsession review of the budget, which, of course, you have. In doing that revision, we took into account recent changes in economic forecasts in the private sector as well as passage of the *Job Creation and Worker Assistance Act*, which contains provisions both on the unemployment side and for investment incentives.

Over the longer term in the budget, we kept GDP growth where we had had it, and long-term GDP growth is still projected to average around 3.2 percent per year, which I would note is also the Blue Chip consensus forecast. During the last part of that period, we have the long-term growth of the country at about 3.1 percent.

What are the mechanics of recovery? Well, the star in the recovery any time is the star in the economy, which is the consumer, since

consumer spending is about two thirds of the economy; and the household sector, of course, which is well known to you, was the star during the downturn and continues to hold up very prominently during the upturn. This holding up, in our view at the CEA, is quite rational and reflects expectations of greater income growth in the future, very accommodated monetary policy, and a tax policy which, while also good for the long term, provided a short-term cushion for consumers.

In order, however, to have a sustainable recovery, I think any economist will tell you that the attention must, at some point, shift to business fixed investment. It is very hard to have a sustainable recovery with the kind of job creation, for example, that Senator Reed highlighted, without much more vigorous investment. As you know, public policy shifted to provide more incentives for investment in the *Job Creation and Worker Assistance Act*. Interest rate climate for investment also remains quite favorable. And something that does not appear to be getting the attention it deserves, corporate profits as measured in our national income and product accounts, are rebounding quite strongly.

And this is a flip side, Mr. Chairman, of the points you raised about productivity. The very modest increases we are seeing in unit labor costs during the recovery have led to a profit rebound. So when most economists – and I would count myself among them – look for an investment turnaround later this year, they are highlighting those fundamentals in a turnaround in profits as well as effects of lower interest rates and investment stimulus.

I think we will continue to see evidence of the investment recovery in coming months. Toward this end, I would point out that most recently the data we got on industrial production are very encouraging, as we had news beyond market expectations.

Now, I said I also wanted to talk with you about risks to the recovery. I think there is too much of a tendency for economists to give you a number and then walk away, and I want to have a very candid discussion with you where I think risks are. And a key risk that I am sure is on your mind, as is it on mine, has to do with the stock market. For example, the stock market has declined about 13 percent since the end of May, and my judgment is that reflects shifts in the equity risk premium and concerns over, among other things, profitability that I mentioned before, and, frankly, concerns over the quality of financial and accounting data.

The upshot of that is a story all too familiar to you that household wealth has fallen by about $1.3 trillion. This manifests itself most obviously to all of us when we look at our pension values, or 401(k) plans or retirement plans, but it has raised concerns in some quarters about the durability of the recovery. So I just want to put a calculation on the table to try to frame how much or how not much of a worry the debt is.

If one were to suppose that the decline in the stock market value that we have seen since May were to be permanent, that is, we just take it forever out of the level of stock prices, we estimate at the Council that the level of real GDP would be lower by between 4/10 to 7/10 of a percentage point after a year. That is a noticeable hit. It by no means

would derail the recovery. And that, of course, is assuming the worst, a permanent hit. It is also important to note that while equity values have fallen, that has been cushioned in part for households by a rise in housing equity, though by no means cushioned as much as a decline in equity.

On the investment side, I would also note as a risk the modest rise we have been seeing in risk spreads, which doubtless contributes to lower equity valuations. In terms of the cost of capital for investment, those risk premium increases have been offset in part by a decline in riskless rate; that is, around the world we are seeing a flight to quality, in economist terms, as people are selling equities and buying bonds.

A part of all this in talking about the risks to the recovery, though, is to ask ourselves about the quality of the data, and I very much appreciate Senator Reed bringing this up. The intense focus we are seeing on monthly or sometimes weekly data releases during the recovery is really focusing the attention, I think, on the quality of economic data. And as the Senator mentioned, the Council unveiled the President's initiative last week to raise the quality of economic statistics. This isn't a parlor game issue among economists; it is about having real-time data that are of use to the private economy in making saving and investment plans, and to you and us in the administration in formulating and thinking about economic policy. We have initiatives for the coordination of data across the statistical agencies that would still protect the confidentiality of taxpayers and firms. I believe this is an initiative that deserves very serious consideration, and hope that it comes to fruition very soon.

Now, I said that I would also spend a few minutes with you on issues about policies for recovery, good policies and bad, and I think one of the issues that has come to the fore in the recovery is the notion of uncertainty. Now, partly, this uncertainty is real. It reflects terrorism risks that perhaps are acknowledged as being larger than they once were or perhaps even new. These are real risks to our economy that one does not easily wave away in the short term.

There are also, however, risks to our economy, both for the long run and the recovery, that come from public policies. Now, we have abundant lessons over the past two decades that testify to the energy and innovation of the private sector. That came up, of course, in the opening statements as well. And I find it somewhat remarkable that some have suggested the growth-oriented tax policy might be making matters worse in urging repeal of the tax cut. I submit to you that is not only bad long-term tax policy, uncertainty surrounding such a discussion weighs on the minds of savers and investors and contributes to an atmosphere of uncertainty in markets.

I will give you a number if that helps. Professor Harvey Rosen at Princeton recently did a calculation that doing a U-turn by taking away the balance of the President's tax cut and looking forward would ultimately reduce GDP growth by just under 2/10 of a percentage point per year. Now, that may not sound like a lot to you, but after 10 years that is about $1,000 in extra output for every man, woman, and child in

the country. The message there, I think, is straightforward: One doesn't want to place the future pro-growth tax policy at risk.

The second pro-growth policy that I worry about is in the trade area. I think we all share generally, if not specifically – and hopefully all specifically – the President's interest in trade promotion authority and open markets and gains from trade. I will spare you the homily on free trade, although I will stipulate that it is true, just to remind you that the institutions for trade are important, and uncertainty about conditions being attached to trade promotion authority is not good business.

The final element of a general uncertainty, before I get to the newer area of corporate governance in the market, has to do with spending. There is often a concern, as, of course, there should be, over deficits and surpluses. But I would submit to you, that is the top layer of the concern. The real issue is overspending and the size of government; that is what determines the current and future tax burdens. Being wary of spending patterns is critical for you and for us.

The final new element I wanted to raise with you is uncertainty over corporate governance. We cannot have the most efficient capital markets in the world, which we have historically had in this country, without trust, and that trust is of two kinds at least. One is faith in the numbers that we see, that they recognize the true state of a company or set of companies. And second is trust that the management of companies will act in the interest of the shareholders in whose trust they serve.

The President, of course, put out in March a 10-point plan focused on two primary areas. One is transparency, that is, improving the quality of information we get as investors or policymakers; and the other is accountability, so that abuses of trust are punished financially, or in some cases in a criminal setting.

The Securities and Exchange Commission, of course, has already made substantial strides here and has asked for several new rulemakings, and, as you know well, has asked for a recertification of statements of the top 1,000 companies. More recently the President called for a new ethic of responsibility in the corporate community, and in the administration we are very pleased with the progress in the Congress in getting both the Senate bill and the House bill out. The President would like to get something soon that he can sign. This is an uncertainty over our economy that we need to resolve, and I commend those in the Congress who have been working very strenuously on this.

Before I finish, I would like to close with one area about which there is no uncertainty. It is, of course, always easy and exciting to look at the events that are in the pages of the newspaper before us, but the truth about our economy's long-term growth today is the same as it always has been. Our standard of living is determined by productivity growth. As we think about policies, be they tax policies, be they regulatory policies, be they the way we approach corporate America, we need to make sure we emphasize growth and innovation.

Thank you, Mr. Chairman. I am delighted to have this opportunity, and I look forward to your questions or any questions Members of the Committee might have.

[The prepared statement of Dr. Hubbard appears in the Submissions for the Record on page 35.]

Representative Saxton. Well, thank you very much, Mr. Hubbard, for sharing those thoughts with us.

Let me begin with kind of a paradoxical question. We here at the JEC constantly monitor a variety of economic indicators, and, frankly, most of those indicators look pretty good. And yet I found myself yesterday sitting in my office talking with some of my staff reaching for the television clicker to turn off the news because it didn't look good. And I thought to myself, why do I need to watch this and put my stomach through arduous kinds of conditions?

When we monitor, for example, growth of domestic product during the first quarter of the year was over 6 percent growth, and in the second quarter it looks like it is going to be about half that, but still significant growth in the economy. Consumption, as you pointed out in your statement, during the first quarter was over 6 percent, and in the second quarter again it looks like it will be – I'm sorry, the last quarter of last year was over 6 percent, and in the first quarter of this year, it was something like 3.3 percent. As you pointed out also, retail sales continue to trend upward. This is good economic news. Home sales continue to be very strong. Business investment, while weak, is not as weak as perhaps it was several months ago. New orders in capital goods are trending up. The Industrial Production Index has been on the positive side for the last six or seven months. The Purchasing Managers Index, which is a measure of the percentage of businesses that are growing, just a few months ago, perhaps at the end of the third quarter of last year, showed there were only 40 percent of the businesses in the country that we measured as growing. Today 56 percent are growing, or thereabouts.

And so there is a lot of good news in the economy, and yet we see obvious signs of other weaknesses. Is this totally because of the accountability and uncertainty factors that you mentioned vis-a-vis terrorism and problems with our accounting processes and uncertainty that develop because of those two issues?

Dr. Hubbard. I don't think so, Mr. Chairman. After September 11th, I started having fairly regular telephone conversations with samples of executives around the country precisely because I felt they needed information faster than the data releases would give it to them. The areas that worried people at the time and worry people still have to do with the timing of an investment recovery. You probably know, CEOs generally have been more pessimistic in that regard than have most economists – not just myself, but many in the private sector. I think that is a source of uncertainty and a wild card that certainly predated the corporate governance issues. I think the corporate governance problem has made things worse because it has added the complication of stock market valuations and probably complicated the investment recovery.

The other issue I would raise, I should follow up on something that Senator Reed had mentioned in the beginning. I think one reason in many people's minds that recovery doesn't feel as good is that we haven't seen job creation at the same pace as we have seen output creation. That will come, but it has been slower and, I think, has slowed down people's perceptions of the times.

Representative Saxton. Well, thank you. As I indicated at the outset, we are going to have some votes around 10:30 both in the House and the Senate. So I am going to have some more questions later, but let me turn to Senator Reed to give him an opportunity before he has to run off.

Senator Reed. Thank you very much, Mr. Chairman. And, as you indicated, the Senate has a vote at 10:30, and I will leave, and I hope my colleagues will return here after the vote.

Again, Chairman Hubbard, thank you for your testimony. There has been some discussion about the results of the first quarter the President pointed to that were very impressive, about 6.1 percent growth in GDP. But wasn't much of the growth in the first quarter based on one-time inventory adjustments rather than underlying strength and sales?

Dr. Hubbard. Certainly a very large factor in the first quarter was inventory adjustments. I expect inventory adjustments will also figure in the second quarter's growth as well. But, yes, they are not final demand changes.

Senator Reed. And so we still haven't seen – well, let me put it another way. That 6.1 percent doesn't reflect a surge in the consumer demand; it is more or less reduction in inventories?

Dr. Hubbard. Consumer demand held up very well in the first quarter; but I don't think any economist will tell you that 6.1 percent is a normal rate.

Senator Reed. Dr. Hubbard, in your testimony, in your remarks, you cited a study by Professor Rosen that estimates that the tax cut reduces the dead weight loss of the tax system by about 2/10 of a percent of GDP annually. Does this calculation take into account the economic effects of the revenue loss and loss of national savings associated with tax cuts? Other studies, I am told, one by Professor Auerbach, found that there is a net loss from the tax cut if national savings goes down. Would you comment?

Dr. Hubbard. I will answer both parts of that. The calculation that Harvey Rosen does was just as I described: It was simply of a tax change. The effects of the tax change through interest rates on the economy are very modest. The best study that I am familiar with was done at the Federal Reserve Board, Elmendorf & Mankiw study. I have a number of very deep technical concerns with the Auerbach paper. I am not sure if this is the right venue to have them. But I do not accept the paper's conclusions.

Senator Reed. Well, we on the Senate side had a hearing on the Banking Committee, and Professor Solow and Professor Stiglitz joined

us. And paraphrasing – and awkwardly paraphrasing – their comments, the suggestion was that national savings will be decreased because of the budget surplus going down, and is unlikely to be made up by private savings given the history of private savings in the country. And without national savings, we don't have the resources for the investment that you think is going to be the leading edge of our recovery. And proposals today to further cut taxes would, I tend to think, further erode national savings in terms of simply decreasing in a more dramatic way the surplus, which is already exhausted through the deficit. Can you comment?

Dr. Hubbard. Sure. The three points you raise: One, I think the base line in that experiment is one that I think is somewhat odd, which is the notion that if you ran surpluses without the tax cut, those would not be spent. I think that, history tells us, is not perhaps the most apt.

The second, on interest rates. While I will skip the general technical differences in the model, in the Auerbach paper, it is built in to have the largest possible interest rate effects; in fact, far larger than any empirical evidence would suggest.

And on the notion of further cutting taxes, I think what I referred to in my testimony was carrying out the tax cut that you have already passed. I wasn't asking you for your consideration for yet another round of tax cuts.

Senator Reed. Well, I seem to hear the President at every possible moment talking about extending and making permanent the estate tax repeal, and making permanent tax cuts that will sunset in 10 years or so. So, is he doing something that you would advise him not to do?

Dr. Hubbard. No. Absolutely not. I think we do want the tax cut that you passed made permanent – good long-term tax cuts.

Senator Reed. Well, so you would want the estate tax cut permanently?

Dr. Hubbard. Everything that you enacted in the tax bill, yes, we would like to make it permanent.

Senator Reed. Well, we already have reached a point where we have a significant deficit of $165 billion, and it keeps going up with every estimate.

In the midsession review, OMB Director Daniels did a preview, and he suggested that the 10-year surplus was significantly caused by the recession, and only 15 percent of the change was the result of the tax changes made last year, the tax cuts. Yet as I look at your report -- the midsession review, actually -- it suggests on page 6 that over the 10-year period almost 40 percent of the change is a result of the tax cuts. Is it 15 or is it 40? And if we cut taxes further or, in fact, increase or make permanent the taxes, will that 40 percent grow even more, particularly, obviously, after the 10-year period?

Dr. Hubbard. Well, I, of course, wasn't here for your conversation with Mitch, so I don't want to talk about his number. But, yes, the tax cut is one of the contributing factors in the decline in the surplus there on

page 6. And over the long term, the static costs of the tax cut are very high. Absolutely true.

Our advocacy, as an administration, for the tax cut and your advocacy in the Congress in passing it, was the belief that it was the right program policy for the country.

Senator Reed. Well, at least in the short run we haven't seen that take hold yet; is that correct?

Dr. Hubbard. I would disagree with that, Senator, respectfully. I think that we have seen support from the tax cut in both the downturn and at the beginning of the recovery. And, of course, the real purpose for tax cuts of the sort that you pass, marginal-rate cuts, is for long-term economic growth.

Senator Reed. Let me just conclude. One of the other issues that was motivating the proposals last year for the tax cut was the notion that it was important to reduce the deficit, and we could do that. That we could, in fact retire Federal debt. It seems now that this is getting more and more difficult. How much debt do you think we can retire now by 2007? I think some of the components of the tax cut would suggest one reason we could cut taxes is because the surplus would grow so large that we couldn't handle it.

Dr. Hubbard. Well, the surplus, of course, is much smaller than at that time. As you know, the unified budget surpluses reappear in the midsession forecasts in the fiscal year 2005 budget, and that is when the period of more aggressive debt reduction begins.

Senator Reed. Thank you, Mr. Chairman.

Representative Saxton. Thank you.

Mr. Ryan.

Representative Ryan. Thank you, Mr. Chairman.

Mr. Hubbard, it is nice to see you here. I have been going through your testimony and listening to your oral testimony, and I just have a few observations and just a couple quick questions.

It is very important that we now look at the threats facing our economy as we try to pull out of the bad news and the problems we have had. And in looking at the President's recent comments, looking at some of the comments from Ken Dam, from the administration, over at the Treasury Department, I have a few concerns.

One concern that I completely agree with you is that the sunset of these tax cuts is producing uncertainty in the economy, when 24 percent of our equity markets are owned by pensions, are owned by people's retirement portfolios, and yet the tax treatment of those pensions from the tax law we passed, for instance, bringing the cap on 401(k)s down by a third, bringing the cap on IRAs down by half, those kinds of uncertainties expiring in eight years put a lot of uncertainty into the equity markets. And we need to fix that and make these tax policies permanent so the market's pension holders in the equity markets know on the income horizon that the tax treatment is certain.

But on the trade issue, you mention we need to go to free trade and pass TPA, I couldn't agree with that more, but I worry that the market see conflicting signals coming from the administration. I reference the steel action, and the lumber action. And also I think that the earnings stripping policy coming from the Treasury Department also has a problem in that it could trigger off a new round of tax treatment against our companies competing overseas. And I worry that the earnings stripping policy that the Treasury has put out may have the unintended consequence of just raising taxes on people who aren't seeking to avoid paying U.S. taxation.

So, I would like to get your comments on the Treasury earnings stripping policy. We in Ways and Means – a few of us here serve on that Committee as well – are trying to clean that up and trying to fix that so we don't trigger another round of perceived protectionism with respect to tax policy.

Spending is also something that I think we need the administration to weigh in on. The President has said a couple of times, we need to hold the line on spending; we need to hit the House target. But we don't hear anything from the administration in specifics and we here in Congress deal in specifics. We break the total spending total down into 13 different bills. We are in a little fight right now on the floor on the first domestic discretionary bill, but we haven't heard anything from the administration on how to get out of this fiscal year with some kind of spending discipline. And if we don't have any partnership or any detailed direction from the administration, my fear – and I think I can share this with a lot of people in this Congress – is that we are going to leave this fiscal year with blowing the cap, which is a Presidential veto threat, and the only budget resolution that exists, which is the House-passed that has been deemed.

On corporate governance – I also would like to get your comments on some of the bills that we have had around here. And I think the markets are worried: Are we going to do overkill and have government and Washington take over the accounting industry, approve the balance sheets and the accounting standards of our corporations; or are we going to pass confidence-building measures that allow transparency, honestly, truthfulness in our records? And is that going to then bring the rule of law back into capitalism, which is what we are trying to accomplish?

And so these are things that are taking place right now. I think the administration, Ken Dam, in particular, his comments that the stock market is still overvalued references that the 1990s were a binge. I think those are hurtful comments to the markets, and I think that they have contributed to a weak dollar policy, whether or not that is the intended policy of the administration. And I also think that some of the policy coming from the administration, probably in an unintended way, gives the impression that our policy shift is away from free trade and toward protectionism, is away from a strong dollar and toward a weak dollar, and is away from spending discipline toward spending more money. And I would like it if you can comment on those.

Dr. Hubbard. You give me quite a list. I will try to go through them.

Let me start with the issue of steel. As you know, the issue in the steel question isn't just whether or not one ought to have a tariff on steel. As a narrowly put economic question, I think the answer to that is obvious. The question is, is this part of the right structural adjustment policy. The President's judgment is that it is, that that is part of what we need to help the steel industry restructure and to pursue the broader trade agenda.

On earnings stripping, we can probably have a longer discussion later, but just to give you a sense of where the Treasury is coming from, is to attempt to go after the source of problems in so-called inversions; rather than banning inversions and meddling in corporate affairs, trying to ask: What is the incentive for this kind of activity? That will inevitably require leveling the playing field, and whenever you level the playing field, there will be winners and losers. And I would very much welcome a chance to talk with you on your concerns.

On spending, this is something where I think the administration has and will continue to provide guidance. For example, on the supplemental, I think the President has been quite blunt as it is on what he would like to see.

On corporate governance, I think in the administration we salute the efforts both that Chairman Oxley has made in the House and Chairman Sarbanes has made in the Senate. And I think we have bills that have very good elements and need to be reconciled quickly. As I said in my opening remarks, this is an uncertainty hanging over the market, and the President would like to sign this soon.

Representative Saxton. Mr. Chairman, unfortunately we have got about 5 minutes left in this vote, so we are going to have to run off. So in fairness to Mr. Ryan—

Representative Ryan. I think he is finishing up.

Dr. Hubbard. Can I give you one last one, and then I will let you sprint? Or I can do it later.

But on the issue of the stock market and binging, I don't think any economist can tell you with perfect certainty whether the market is overvalued or undervalued. What I can tell you is that the fundamentals of the economy are very, very good, and that it is very difficult to see anyplace other than the U.S. to be the best place to invest.

I would advise you not to carry the binge analogy too far in the sense that what we have left over from the 1990s is an economy that has wonderful technological innovation and productivity growth. It is the engine and envy of the world's growth.

Representative Saxton. Thank you, Mr. Chairman. We will go get this vote out of the way and be back as soon as possible, and when we return, we will go to Mr. English.

[Recess.]

Representative Saxton. Mr. Chairman, hopefully we won't be interrupted again for some time. Let's go to Mr. English at this point.

Representative English. Thank you, Mr. Chairman.

Chairman Hubbard, it is a privilege to have you here. I must say, when I am in Erie, Pennsylvania, I get a much less optimistic view of the economy than I do when I am here within the Washington Beltway. Our concern there is the things that we specialize in, which are particularly manufacturing; Erie County, Pennsylvania, has the biggest concentration of manufacturing jobs and export-related jobs in our entire State. We see our local economy very much tied to the manufacturing cycle, so I am going to concentrate the focus of my questions on that.

In your testimony, you say that the key to transforming recovery and robust growth is the pace of business-fixed investment. And then you reference what we were able to do in the very limited stimulus package that the Senate permitted us. That makes a great deal of sense to me. And then you also note: For the economy as a whole, business investment slowed its decline during the first quarter. Investment in nonresidential structures continues to decline, but purchases of equipment and software have shown some signs of firming.

In a second, I wonder if you could respond to that, and also respond to the question I – one of the hats I wear is Chairman of the Real Estate Caucus. Should we also be looking long term to incentives to encourage investment into nonresidential property as something that will add – value added to the economy?

I would like you, though, specifically to comment: Do you foresee a sustained rebound in manufacturing? Do you feel that the recent decline in the value of the dollar will have a significant positive effect on manufacturing and its competitive position in the United States?

And, finally, as Chairman of the Steel Caucus, I may have a little different view than you and some of my colleagues on the President's steel policy, which I think is revolutionary and shows the courage of being willing to think outside of the box. But I wonder if you would comment on what trends you see in steel prices, and how that is going to affect not only steel companies, but the manufacturing sector as a whole.

Dr. Hubbard. Thank you very much. A number of very good questions.

First, let me set the record straight. I absolutely support the President's steel decision.

Representative English. I got that.

Dr. Hubbard. I think it is an excellent example of corporate restructuring.

On the questions that you asked, I think that we do have a manufacturing recovery under way. The National Association of Manufacturers, I think, would agree to that in terms of surveys of its members. And we are starting to see more robust upturns in industrial production.

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Yes, I do think a decline in the dollar is part of the story for manufacturing, just as it was part of the story for manufacturing's decline.

On the question about nonresidential property incentives, I think this is really a topic for discussion under tax reform. I would prefer, at least, to see a general discussion of how we tax capital and investment in the country, rather than doing it in a run-off way. One of the things I thought that was particularly good about the investment incentives that the Congress had passed before, was that they were a move toward a more neutral tax system, the business investment. I certainly salute that.

Representative English. And on that point, Chairman, if I might interrupt, one of my concerns was that our focus, because it was a narrow, limited bill, and because the Senate constrained Congress's approach to a stimulus package, we did not provide a similar series of incentives to encourage investment in business structures, in business property. And I wonder if you see that as an imbalance that we should address long term?

Dr. Hubbard. Well, I think the first and most important short-term consideration there will be the recovery of the economy itself, because the lumpiness of structures are naturally going to be slower to recover than equipment. I would urge you to think again in terms of bigger tax reform issues rather than focusing on it as a stimulus per se.

You asked the question about steel prices. Of course, steel prices will track very closely the economic recovery, as steel is a basic input.

Representative English. So would it be fair to say that, in your view, one of the critical things in the President's policy on steel is that by encouraging the economy overall to recover, essentially that is going to help the steel sector, which is closely tied to the performance of the overall economy? There is a tendency for many to break out the 2001 action as a freestanding, comprehensive policy. In fact, I see the President's approach to steel as being much more nuanced and much broader. And, in fact, the recovery of the manufacturing sector is likely to be the most effective way of providing recovery to the steel sector. Is that a fair summary?

Dr. Hubbard. That is absolutely true. The best policy for industries tends to be a policy that helps the economy as a whole. The piece of nuance I think that you were referring to, is the President wanted to use this action as a way to encourage restructuring in the steel industry, and we await that restructure.

Representative English. I thank the Chairman.

Representative Saxton. Thank you very much, Mr. English.

Ms. Dunn?

Representative Dunn. Thank you very much, Mr. Chairman.

And welcome to you, Chairman Hubbard. I enjoyed and appreciated your answers to Mr. Reed's questions on the tax relief proposal that the President signed last year. And we need to go ahead to create permanency in some of these items. I think that, especially when it comes to the permanent repeal of the death tax, when people do have that

sense of certainty, it is at that point where they change their behavior. And so, I think that that is very important to make sure that the dollars that continue to have to be put into life insurance coverage and estate planning be allowed to be put back into the companies. And I think that will help and boost our recovery to a much greater degree.

I was very interested in your conversation with Mr. English on steel, and I will hope at some future point that you will be able to tell us that the industry actually has begun to restructure. That will be the question I look at when I analyze whether that is proper policy, since it is going to be in effect for 3 years. I hope that we will see some examples of how that is occurring in the way that the President would like it to.

I did have an opportunity, Dr. Hubbard, last spring, to listen to your testimony on the Ways and Means Oversight Committee, and you talked about the effect of dynamics. That is of great interest to me, and I supported your candor – or appreciated your candor, I guess, in talking about how difficult it is to try to bring reality into the scoring process. And you suggested that that would be possible and practical on large-scale tax bills.

In your opinion, when Congress evaluates the merits of large tax changes, do you believe it would be beneficial to Members to see maybe more than one, maybe several different economic models being used to evaluate those tax changes?

Dr. Hubbard. I do, absolutely. I think that when you make your deliberation over tax policy, what, of course, you are concerned about, is effects on the economy and distribution of the tax benefits and costs of what you are considering. And I think you implicitly look at models or effects on the economy in your deliberation.

What I would like to see done is to provide more systematic help, and I don't think it has to be a single answer. A range of answers would help inform the debate. And I am not sure it is a great analogy, but the way I think of it is more like an impact statement, to give you the kind of information as a policymaker, that you need to figure it out. So absolutely, I think it is important for large tax bills.

Representative Dunn. And I also see the need to create that broad perspective and knowledge when it comes to trade legislation. I think we penalize ourselves often by requiring a revenue statement on what a change in trade policy is going to bring about, when so often the effect of free trade is to increase revenues, and so it becomes almost a false statement. And I come from the State of Washington, which we just learned has finally dropped in its unemployment numbers a bit. They have continued to be number 2 in – among all states in the Nation – after Oregon, Washington State is. And I am very hopeful that as we work together with the administration, that we can come up with those tweaks that need to be done to assist us in moving forward economically, to make that turnaround of the economy happen sooner rather than later. And so I appreciated very much your summary of what the uncertainty elements were, because it has given me some thoughts on what needs to be done. Thank you, Chairman Hubbard.

Dr. Hubbard. Thank you.

Representative Saxton. Thank you.

The gentleman from Florida, Mr. Putnam.

Representative Putnam. Thank you, Mr. Chairman.

Good morning, Dr. Hubbard. I want to briefly address the issues of consumption of household debt. As has been noted by people a whole lot smarter than I, the household consumption in housing buoyed us through the recent slowdown. The consequence being that, as we are poised for recovery, there is a lack of pent-up demand. Does this give you any concerns?

And also, as a result of the consumption continuing throughout the slowdown, much of that was done on credit. And I would like for you, if you would, to address household debt and its impact on being a drag on recovery.

Dr. Hubbard. Well, to take the question, at least start actually on where you ended up, on the recovery, I don't think it is the case that you need an acceleration of consumer spending to have a decent recovery. As you noted, consumer spending was robust during the downturn and continues to be so. What is needed for more sustainable recovery is the recovery in investment. And I want to come back to that in just a second.

On your issues of whether households are strained, like many things in looking at these ratios, it depends on what you look at. I think people tend to focus on changes in balance sheet variables, in looking at households taking on more debt. And you are correct that that has happened, but debt serviceability of households has actually held up very well. In part, this is a statement of the low interest rate climate in which we find ourselves.

Now, is this a wise thing for households to do? And here I will come back to the investment point. Households are making a bet, if you will, that the economic growth forecasts that are, say, in the administration's documents or in the private sector forecasts, will come to pass. It is income growth that is the largest determinative of consumer spending. I think that is a very reasonable bet. Are there wild cards in the risks? Yes. And they are the ones that I mentioned in my testimony particularly having to do with the value of equities. But I think at the moment, households have a very reasonable bet, and I see nothing in what has happened to suggest that we are likely to see a fall in consumption.

Representative Putnam. The issues – the consumer confidence from the University of Michigan last week showed a dip. In your conversations with executives, and particularly retailers, as they are making their purchasing decisions for the Christmas season now, what are you hearing out there in terms of their expectations for the holiday season?

Dr. Hubbard. Well, first, on the confidence, what appears to have happened, the dip isn't so much an impression about current conditions, but in questions have talked about the situation going forward, which is

a code word for worrying about the stock market, since it is really coming down to the same wild card that I mentioned before.

Among retailers, perhaps the most brisk positions are retailers at the middle and lower price points for products. But I expect this should be a relatively good retail season, given the aggregate of consumption forecasts we have seen.

So, yes, there is reason to worry at some level about the confidence factors you mentioned, but, again, I think this is all back to the question of the market.

Representative Putnam. In the Daniels mid-session review, one of the things that came out was that at its high, somewhere along the line of $600 billion of government revenues were generated by the capital gains tax. It raises some interesting questions about the dependence on that particular tax for government revenues. Obviously, that is not going to be the case now or in the near future, and there will be a lagging effect on revenues as a result of the low market. So, comment on that, please, if you would, our new-found dependence on capital gains as a source of federal government revenues.

Dr. Hubbard. Well, I think the pattern that Mitch was referring to and that you raised is actually part of a more general story in the tax system of how dependent we are on the decisions and incomes of very high-income taxpayers. In the capital gains story, it is really two stories. One is a story about just investors realizing gains; another is the compensation of very high-income folks in corporations. And I think what we saw in the 1990s, as you would expect in a big boon for the economy, is an increase in that compensation, and we are now beginning to see and probably will see a decline in that compensation. A tax system that tries to load up its principal burden on high-income taxpayers will be very sensitive to the income movements of those taxpayers. Capital gains would be an element, but I think it will also show up in individual income taxes generally.

Representative Putnam. Does the imbalance of the tax base and its disproportionate burden, if you will, on those high-income ratepayers, is that troubling to you as an economist in terms of when you have a setback in the markets, as we appear to be in now, it has a disproportionate effect on revenues? What are your thoughts on that?

Dr. Hubbard. Well, I think it is actually a little more complicated. We, of course, have a progressive tax system, so the general pattern you mention wouldn't be a surprise. I think what was a surprise to at least us in the administration, and I think to many private sector forecasters, was just how much the revenues depend on that.

Let me give you a quick example. You probably know between the budget and the midsession, the actual forecast for economic growth was increased. And so typically you would say, well, then we should be bringing before you an increase in revenues. Of course, that was not the case. And that change in economic growth was more than offset by these

yet unexplained changes on the tax side. So, it is an area that we are still just really coming to grips with.

Representative Putnam. I certainly agree with you, we have a progressive-rate structure, but it has almost reached a point of being super-progressive in the sense that you have a huge percentage of people who pay nothing and a very small percentage of people who pay a majority. And that is troubling when you get into situations like we are in now, where you have a tremendous fall-off in capital gains and in those upper income, those margins, and it has a disproportionate effect on revenues.

Dr. Hubbard. I would agree with you about that. I think the principal troubling factor for me is simply that high marginal tax rates generally are bad for our economy. And I think any continuing discussion of tax reform that would push us toward a broader-based lower-rate tax system is absolutely a good thing.

Representative Putnam. Thank you, Mr. Chairman.

Representative Saxton. Mr. Hill.

Representative Hill. Dr. Hubbard, thank you for being here this morning. I appreciate your comments.

I guess the question I have got in the back of my mind is, you have got statistics here showing that this economy is going to be growing at 6.1 percent. If that is the case, then why are we running deficits? If the economy is blazing along at 6.1 percent, why aren't we getting the revenue in to create surpluses rather than deficits?

Dr. Hubbard. Well, I guess the first part of the answer I would give is, of course, we are not projecting 6.1 percent. That is a statement of what happened, not what will happen. I think the potential growth rate of our economy, which is obviously a debate among economists, is a little over 3 percent per year. That is the sustainable GDP growth rate for our economy. That is what we have in the budget. I think it is actually higher than that, but we try to be conservative.

Your question about revenues gets back to the previous discussion I was having with Mr. Putnam, which is that while we have forecasted higher growth, to be as straightforward as possible, the effective tax rate on income appears to have gone down, and that is in part due to lower capital gains realization and the decline in income among very high-income households. So I think that is part of the puzzle. And I don't think anyone would suggest the economy is likely to be growing at 6 percent.

Representative Hill. Well, what does this mean then? In early February – I am reading from the Joint Economic Committee Democratic staff. It says: In early February, most analysts expected that the real growth domestic product would grow at 1.6 percent annual rate in the first quarter. In fact, GDP grew at 6.1 percent. Does that not – is that not right?

Dr. Hubbard. That is what I am saying. In the past, in the first quarter, GDP did grow at 6.1 percent. I would count myself as among

those who were surprised by the strength largely having to do with, as Senator Reed had pointed out earlier, the strength of the inventory cycle at that point. The projections for the rest of the year in the Blue Chip would be, I believe, for the second quarter something like 2.6 percent and 3.3 in the remaining two quarters of the year.

Representative Hill. Why are we running deficits then if we are growing this strongly?

Dr. Hubbard. Well, the sources of deficits are many, having to do with weaker receipts from the past, i.e., the downturn, having to do with increases in spending and with, frankly, the needed build-up in some areas of spending in defense and homeland security. As you know, from the midsession document, the administration's forecast is for unified budget surpluses commencing in the 2005 fiscal year budget, which would be the last budget the President would submit in his first term.

Representative Hill. Well, let me ask you a different question then. Do you believe that paying down the national debt can make an important contribution to national savings and economic growth?

Dr. Hubbard. I think paying down the national debt will be an excellent contribution to national savings.

Representative Hill. But we are not going to be paying down the national debt; we are going to be increasing it.

Dr. Hubbard. Well, the forecasts show that after the 2005 budget, we continue to have the unified budget surpluses, which would be used for debt reduction, unless the Congress decides either to change taxes or spending policy.

Representative Hill. Well, 2005 is a long way off; and as we know, a little more than a year ago we had a discussion about whether or not we should do tax cuts or not. And I remember part of that discussion was whether or not it was going to generate deficits if the economy went south. Well, the economy did go south. We had September 11th; we are now experiencing huge deficits. You are telling me that, in terms of economic growth and vitality of our economy, that paying down the debt is a good thing. In this year we are running approximately $320 billion deficits. We are not -- we are not following your advice. You are saying that paying down the debt is a good thing that we should be doing; that in the foreseeable future we are not going to be doing that.

Dr. Hubbard. Well, if I might take your question in two parts. In the short term, in the budget forecast in the midsession review, the tax cut plays decidedly a bit player's role in the deficit. In fact, for the first deficit reported there, the tax cut is actually a relatively small component, because, as you know, the size of the tax cut gets larger as you go out. So it simply isn't the story. The story there is rather the weaker economy and spending.

When you asked should we pay down national debt as to whether that would increase savings, I, of course, said, yes, that would be automatically true. But the question for policy isn't that arithmetic question; it is relative to, what? If you wanted to start with this

midsession and decided you wanted to run larger surpluses, you must do one of two things: raise taxes or cut spending. And so the question would be, do you think economic growth for the country would be greater if you pursued that policy to raise surpluses? I think not. But that would be the question to ask.

Representative Hill. Okay. Well, I see my time has run out.

Representative Saxton. Thank you, Mr. Hill.

Senator Bennett, welcome to the House side.

Senator Bennett. Thank you, Mr. Chairman. We had a vote. I see Senator Reed got here before I did. I apologize, but the vote prevented me from getting here before this.

First, very quickly, over the Fourth of July holiday I went with the Leader, Senator Lott, and some other Senators to a number of places, among them Ireland, which is now called the Celtic Tiger of the European Union. And we visited with the Prime Minister of Ireland and said, how have you gotten your economy turned around from being the sick man of Europe with unemployment in the high teens, if not low 20s, now to the strongest economy in Europe? And he said, three things. We had a stack -- he held up his hand. He said, we had a stack of business regulations this high, and we shrunk it down to this. Number two, we cut the corporate income tax rate to 10 percent. And, number three, we cut the capital gains tax rate in half. And now here we are.

Now, I am not sure it is that simple, but those were interesting comments.

Now, let us get back to this whole question that we have been discussing here. I have always held that paying down the debt in numerical terms was the wrong holy grail to chase; that the significant number we should look at is the size of the debt compared to the size of the economy. And I agree with your numbers. Chairman Greenspan yesterday forecast growth this year of about 3-3/4 percent. Coming off the very strong first quarter of 6.1, that means relatively anemic growth for the other three quarters to come out at the end of the year 3.5 or 3-3/4. Nonetheless, if the economy is growing at – to keep the numbers simple – let's say 3 percent, and the national debt is growing at 2.9 percent, doesn't that mean we are moving in the right direction, even though the debt is going up in numerical terms?

Dr. Hubbard. Absolutely. And I would just add one qualification to that, Senator, if I might. A corollary point to that is what is really important is the size of government and the spending that is giving you that debt in the first place. But, yes, your analysis is right on.

Senator Bennett. And the other thing the Prime Minister of Ireland said when he was talking about the corporate tax rate of 10 percent, he said, I am less concerned about tax rate than I am with tax take. And we have found that our tax take has over time gone up as we cut our tax rate down. Now, we are talking about raising taxes.

I agree with your point that the tax increase that we passed last year had virtually no significant impact on where we are right now in terms of

deficits, because it was a relatively small percentage of the shortfall, and, in fact, all of that was programmed into our forecast. Isn't that true, that we forecasted the shortfall by virtue of the tax—

Dr. Hubbard. That is true.

Senator Bennett. So all of the shortfall, in addition to the tax cut, has come from one of three things: the slowdown of the economy, the increased defense spending, and the increased spending for homeland security. Is that fair to say?

Dr. Hubbard. That is correct.

Senator Bennett. Now, let's try to look ahead. And I understand there is nothing more difficult than an accurate forecast. Indeed, I have come to the conclusion since I have been here, there is no such thing as an accurate forecast, and I have never seen one. We all end up either high or low. We think we are heroes if it is higher, but, in fact, we are just as big chumps if it comes out that we get more money than we thought, as we are if it comes out that we get less money than we thought.

Assume that this recovery goes along the lines Chairman Greenspan outlined yesterday in his testimony, and that we are about 3-3/4 this year and 4 percent next year, and then project from that forward. Is the tax cut that then starts to kick in going to have a significant impact on slowing down the economy in those outyears?

Dr. Hubbard. I don't think it will, Senator. In fact, quite the opposite. I think that in our forecasts – and I certainly, again, can't speak for the Chairman - you would have to ask him. But I also believe in forecast, the impact of tax policy is present in measuring economic growth. So the effect is, if anything, positive.

Senator Bennett. So you think perhaps the economic growth will be higher by virtue of the tax cut kicking in that period?

Dr. Hubbard. Absolutely, Senator.

Senator Bennett. So you would agree with the Prime Minister of Ireland then.

Dr. Hubbard. Well, I certainly agree that any policy that reduces marginal tax rates, broadens the tax base, and lowers the tax rate is good tax policy.

Senator Bennett. So even if the deficits persist into 2005, if the economy is growing at a faster rate than the debt over that period, in terms of the legacy we are leaving our children, we are making progress?

Dr. Hubbard. That is correct. And we are certainly improving not just the legacy for our children, but the lives of people in the here and now, because we will have better economic growth and better employment.

Senator Bennett. Well, we are in the process of debating in the Senate a prescription drug benefit that has not been scored, so we don't know how much it will add to spending, but the estimates have been made by the people that have looked at it that if we were to take the most expensive one, it would add a trillion dollars to the deficit over the next

10 years, and the next 10 years are the easy ones. That is, the impact of that kind of an entitlement over the next 20 years will be much greater, but we are not allowed to score beyond 10 years, so we have to stop at 10 years. But the 10 years is ramping up like this, and then it starts to take off. If we can do prescription drugs for substantially less than a trillion dollars, wouldn't that have a very significant benefit for the economy long term?

Dr. Hubbard. Well, the key, of course, in the Medicare prescription drug debate is, first, what is the right policy for people, for seniors? We believe in the administration it is possible to focus on lower-income households, and with programs with competition and choice, it would be substantially less.

Senator Bennett. But let us leave the policy aside for a minute and just talk about economics. If we were to choose between policy A -- let's assume the policy is defensible in both cases. Policy A that costs us 400 billion over the next 10 years, and then the base thereafter from that level, or a trillion over the next 10 years with the base from that level, which would be the most damaging to the economy?

Dr. Hubbard. Well, from the pure spending effect, obviously the larger one. The only caution I would leave you with is, of course, you want to decide on the merits of the policy and trade that off against that cost. But, yes, the larger one would be more costly.

Senator Bennett. As I say, let's assume for the sake of the argument that either one is a defensible benefit in terms of what you are trying to accomplish. Well, I lay that down because that is a very significant economic circumstance that we are debating right now. The House's prescription drug benefit is, as I recall, 350 billion over the next 10 years.

Representative Ryan. That is right.

Senator Bennett. The proposal that would have come out of the Finance Committee, if the Majority Leader had allowed the Finance Committee to meet, would have been 370 billion. And I understand the proposal that the Majority Leader is in favor of would be a trillion dollars, but we don't know because it has not been scored. And we will have that debate. Senator Reed and I will undoubtedly have a lot to say about that as that goes forward, and I am sure his view will be somewhat different than mine.

Dr. Hubbard. If I might, on that very point, Senator, I think the costs that you are trying to get at for the economy aren't simply the fact that government debt is higher; you borrow more, and there will be an interest rate effect. That is really the tail, not the dog, that is wagging. The dog that it is wagging is that future taxes have to be raised, and that means crowding out productive activities. I think you put your finger on a very good concern.

Senator Bennett. Thank you, Mr. Chairman.

Representative Saxton. Senator, thank you.

Senator Reed and I were just chatting. There is a lot of interest here in hearing further from Dr. Hubbard. Perhaps we could have another

second round, but maybe we could limit our questions to a minute or two, and we will go along those lines.

Let me just begin with something that I am very curious about to see, and to see if the administration has focused on this. We experienced two decades of really robust economic growth with a very short interruption in the short recession we had in the early 1990s. And one of the things that JEC does is to try and identify the things that government is doing right and some of the things we are doing wrong. And we have identified four or five factors that we think played a strong part in that long period of growth. One is, obviously, monetary policy, which the Congress doesn't have a whole lot to do with. Another is tax policy, which we do have a lot to do with. A third is promoting international trade, which we hope that we have something to do with. A fourth is spending policy, which, beginning in the middle 1990s, we began to slow its growth.

But the fifth is the subject of my question. We discovered, and I was surprised – maybe I shouldn't have been – but I was surprised to see the effects of American productivity based on investment in technology during the two decades of the 1980s and the 1990s. And my question is this: Has the administration focused on this last factor, productivity and investment in technology, and the effect of the diversion of resources to the necessary expenditures and activities involved in protecting our country and our citizens against terrorism?

It seems to me that we are diverting large amounts of resources for this very necessary purpose. Has the administration focused on what this means and the potential effect on economic growth?

Dr. Hubbard. Yes, we have, Mr. Chairman. In the most recent economic report of the President – there has been a long version, and the short version I will give you now.

If you imagine doubling private sector security expenditures and an increase in the security expenditures that is being done in the public sector, we estimate that productivity growth could fall by about a tenth of a percentage point per year for a few years. That is noticeable. It is not a killing. It does suggest the need to keep that number as small as possible, as your question suggested, by making sure that we give the right incentives for the private sector to innovate ways to meet those security requirements as opposed to being overly regulatory.

I would say, in terms of productivity in the country, if I might, that the biggest component probably for American productivity comes from the institutions in our economy. We are often quick to jump to technology investment, but the truth is American productivity growth has been very high relative to Japan and Europe, two areas which, of course, have access to the same technologies that we have.

So I think there is a complicated story there, and I certainly salute the Committee's longstanding interest in that.

Representative Saxton. I guess my only other thought on this subject that I will get into here is that it seems to me that our tendency in dealing with terrorism is to deal with it in a very broad spectrum. And

maybe one of the things that we need to do is to try to do a better job in identifying where the threat really exists, because we can't protect everything, and I think we are trying to do that at the moment. And it is just a concern that I have about the wisest uses of our resources.

Dr. Hubbard. I certainly agree with that; good cost/benefit analysis is needed here as in other things. And that, of course, would be a good chunk of what the management of the new Homeland Security Department would be doing.

Representative Saxton. Thank you.

Mr. Reed.

Senator Reed. Thank you very much, Mr. Chairman.

And, again, thank you, Dr. Hubbard, for your testimony.

I have listened, and I think you have said quite clearly several times that the key to our recovery economically is stimulating investments. That is why I am still a bit puzzled why the administration would take such a strong position with respect to the estate tax repeal, making it permanent. It seems to me that it affects very few people so that the cumulative contribution to investment would be very small.

And also, I think you have got some tricky timing issues. Most people don't die on the advice of their accountant; so, as a result, when you go out and speak to groups and the President speaks to groups, I think there is disconnect because I think particularly sophisticated financial advisors can understand investment is important, but when you trot out the estate tax and essentially the same speech that was given a year and a half ago before 9/11, before this recovery, I think the perception is, one, you don't get it; or, even if you get it, you are not going to do the things that are necessary to do to really move the economy forward. But particularly troubling to me is the case of the estate tax. Could you comment?

Dr. Hubbard. Sure, on actually the multiple parts of your question. I think the principal reason to oppose the estate tax is not so much the investment effect -- I am going to get to that in a second -- but just a question of whether it is appropriate in society to add yet another layer of capital taxation on top of multiple layers that have occurred before. I think it is an issue of tax fairness.

On the issue of investment --

Senator Reed. It exists already. We are not adding it.

Dr. Hubbard. But if you are not going to make it permanent, you are indeed putting it back on.

Senator Reed. Now we are getting into linguistics. Go ahead.

Dr. Hubbard. But your question was about investment. In there, I think economists see the estate tax for what it is, which is a tax on saving and capital accumulation. It feeds definitely into the required rate of return on capital in the economy. I can't imagine anyone who could argue that the estate tax, that is somehow a tax that in and of itself would

promote investment. There are reasons to have a debate over size of the estate tax, but I don't think that is important.

Senator Reed. Just not to belabor the point, but if you are here – and I think you are – saying we had better get investment stimulated dramatically, and in the short run we will see the economy recover, but in the repertoire of approaches that you and the President continually urge, there are provisions that will have very little, if no, effect in the short run, in the medium run on investment. And it just seems to be a disconnect. And when you speak to financial markets, I think they understand that. Most of the brokers there would love to see the estate tax repealed because it would be personally beneficial, but they understand it is not going to move the economy. That is one reason I think you see the President speaking and the market diving simultaneously.

Dr. Hubbard. I don't agree with that, with due respect, Senator. I don't think there is a disconnect at all. The dominant factors in the investment recovery are likely to be what I laid out in my testimony to the recovery of the economy itself: low interest rates, the investment stimulus package which you enacted. Making the tax cut as a whole permanent is not only good tax policy; it does remove a sense of uncertainty about the collection of fiscal policies in the country that I believe, for what it is worth, does weigh on the minds of the market.

Senator Reed. Thank you, Mr. Chairman.

Representative Saxton. Mr. Ryan.

Representative Ryan. One thing that I think ought to be added to the answer to Senator Reed is that the estate tax itself is the single greatest destroyer of the transfer of businesses from one generation to the next, and so it is a job killer. And that is also an issue that I think needs to be dealt with in that debate.

What I wanted to ask you about is this whole idea that seems to be dominating the discussion up here on the separation of the corporate managers with the interests of the shareholders, and the debate is a very important debate. And now we are trying to find ideas to connect the interests of the managers with the interest of the shareholders.

The answer inevitably always comes up to more regulation. And I wanted to ask you about an alternative to that, which is directed at reforming, repealing, or amending the Williams Act and other laws like that, which, over the last couple of - last decades, have made it much more difficult for takeovers of corporations, particularly hostile takeovers. We have had a lot of different laws passed in States, different laws that have been passed in the Federal Government, that make it virtually impossible for tender offers to be offered and to be received, which puts pressure on corporate managers to perform well and to perform in a way that the shareholders would like them to perform. And it is a system that, prior to preventing these kind of takeovers, basically you had the shareholders in the driver's seat. The shareholders, if they

thought they could bring in better management, improve their stock price, had a way to do it; they had a vehicle to go to.

And I just wanted to know if you had any comments on that, any opinions on that, and is the administration at all looking at maybe revising some of these laws so that shareholders can have a chance at better management if the management that they had in place is, you know, running the company into the ground?

Dr. Hubbard. Well, of course, you raise what corporate finance specialists would call the key problem in corporate finance, the agency problem. The shareholders own the firm, but it is the managers who carry out the decision.

I think government does have a very strong role to play there. In particular, getting information out helps the shareholders understand what management is doing, and in setting the rules of the game for accountability for management. I think that has been the theme of both what the President asked for and what the House and Senate are doing.

I think, however, what we know in corporate finance also is that additional good effects can come from the empowerment of large shareholders. Much of our shareholdings, of course, are concentrated in institutional investors, and making sure that institutional investors have the incentive and ability to carry out their monitoring role is important, and making sure that the market for corporate control works very well is very important. That is where, as you suggested, the rubber meets the road.

I don't want to comment on any specific pieces of legislation, but I think that is an area that deserves emphasis.

Representative Ryan. Thank you.

Representative Saxton. Thank you very much.

Mr. Putnam?

Representative Putnam. Thank you, Mr. Chairman. I want to also echo Mr. Ryan's remarks on the estate tax, and point out that Mr. Hubbard's own testimony says that while entrepreneurs constitute a minority of the people, they are three times more likely to be subject to the estate taxes, making the tax drag on asset accumulation in a risk-taking economy, reinforcing the point about the hyper progressivity of our Tax Code, and that it is confiscatory, and mostly impacts people who tend to be, as we say at home, land rich and cash poor.

And as a segue, a lot of those people are in rural America, and a lot of them are brokers in the Northeast and all, but a lot of them are in rural America dealing in agriculture where they have a high level of assets, but not a whole lot of cash. And even in the most robust of times in the past decade, it has been pointed out by everyone, including Mr. Greenspan, that the one sector of the economy that has been left behind is agriculture in rural America.

And my question to you: Is this a painful but necessary restructuring of market forces, where we have towns disappearing, and we have a tremendous depression in rural America, or is it something that can be

corrected by some policy changes to effectuate a balance to have a sustainable rural economy in this country?

Dr. Hubbard. Well, I think, starting at the beginning of your question on the estate tax, I think interest in the estate tax is not so much whether it affects rural Americans or urban Americans, but that it is just bad tax policy. It violates simple norms of tax, and it is grossly inefficient. It is as bad for the urbanite as it is for the farmer, even though the farmer might appear to some more sympathetic.

On the issue of agriculture communities, there, of course, isn't a policy magic wand to wave, but I think there is work that we can do in place-based aid in farming, and in supporting environmental and conservation programs, which, of course, is part of the recent farm law.

Representative Saxton. Thank you very much.

Mr. Hill.

Representative Hill. Dr. Hubbard, the economy is growing, but the stock market is going south. What is this all about?

Dr. Hubbard. Well, of course, the first honest disclaimer I would have to give you is no economist could give you the absolute perfect answer to that, at least speaking for myself. I will give you my impression as to what is going on.

What economic data are telling you is about the performance of the economy in real-time. The stock market tells you several things. It tells you, first, what expectations are for future profits of companies, and then what the right way to discount those is, what do you think the uncertainty surrounding performance is.

To get to your question, what the stock market, I think, is telling us is not that future profits are likely to be low. Everything we know about the profit turnaround and what we are seeing suggests that is not the case. But there is uncertainty about the accounting data, the corporate governance issues, and, frankly, there is also real uncertainty having to do with terrorists and risks and general responses to those.

Representative Hill. So what should we be doing to restore confidence in the market then?

Dr. Hubbard. Well, I think that the Congress and the President have been taking the right steps in trying to focus on transparency and accountability in the corporate sector to make sure that accounting data have real meaning to investors as well as to managers, and that people who abuse the public trust are punished.

Representative Hill. So you think this decline in the stock market is entirely due to corporate misgivings?

Dr. Hubbard. No, I do not. I think that we have seen a decline in stock markets around the world and in regions with different accounting systems and a flight to quality, if you will, moving from equities to bonds, treasury equivalents in different countries. So I think the story is more complicated than simple corporate governance.

Representative Hill. Do you recognize a recovery soon?

Dr. Hubbard. In the stock market or—

Representative Hill. In the stock market.

Dr. Hubbard. Well, the stock market is pricing fundamentals. I think when the fundamentals of the economy become very clear, as they will when profit reports come out, it becomes much easier for the market to react.

Representative Hill. One last question. Earlier I asked you a question if paying down the national debt could make an important contribution to economic growth, and you agreed with that. We should be paying down the national debt, correct?

Dr. Hubbard. I think what I agreed with was the first part of that, which was national savings.

Representative Hill. But do you believe that paying down the debt can contribute, as Alan Greenspan believes, to economic growth?

Dr. Hubbard. Modestly. I think the empirical effect there is actually quite small, to be honest with you, based on studies done at the Federal Reserve and elsewhere.

Representative Hill. All right. We all have our propaganda, and I have got mine in front of me here. I want to ask you a question relating to this propaganda that I have in front of me here. It says that – what I have here is Director Daniels issued a one-page preview of the midsession review. This document includes the claim that the recession erased two-thirds of the projected 10-year surplus, and the tax cut generated less than 15 percent. On page 6 of the midsession review, there is a table showing that the tax cut was responsible for almost 40 percent of the deterioration. What is your view? Is it 40 percent, or is it 15 percent?

Dr. Hubbard. Well, I don't know, of course, the precise document you are talking about. From OMB, our numbers in the administration are as printed in the midsession. My guess is there must be confusion about talking about a single year, which that sounds to me about right, versus a very long period of time. There is no question over the long period of time that the tax cut contributes to economic growth and revenues.

Representative Hill. Well, I didn't ask you that question. The question I asked you, is it 15 percent or 40 percent of debts?

Dr. Hubbard. As I said, Congressman, it depends on the horizon. Without knowing what you are talking about from an OMB document, in the first year, the 15 percent sounds about right. A very small component, as I said earlier, of the deficit comes from the tax cut. Over the longer period of time, the 40 percent number sounds about right.

Representative Hill. Okay. The Chairman says my time is up, so—

Representative Saxton. Thank you very much. Senator Bennett.

Senator Bennett. Thank you, Mr. Chairman. And thank you for the second round. I think this has been a worthwhile dialogue.

I come back again to the fact that there are no certainties in this business. There are no hard and fast forecasts. I have never seen a

forecast that turned out to be correct more than maybe 15 days after it is made. You go out to six months or to a year, whatever forecast, whatever percentages that are quoted, on either side of the ideological debate, they always prove out to be wrong. And the reason is – as difficult as it is for those of us in Congress to understand – we don't control what happens in the economy.

There were some yesterday that said gleefully during our hearing with Chairman Greenspan, "Mr. Chairman, since you started testifying – when you started testifying, the market was down 166 points, and now it is only down 40." And, of course, it ended up down something like 170 after he left the stand. And we could tell ourselves that if we could just keep him on the stand filibustering, somehow the market would go up. But the market doesn't pay nearly as much attention to what we say on Capitol Hill as we do. And, before coming here I checked, and the market is up – at least as of the time I left, the market is up over 170 points, and nobody said anything.

The fact is the market is responding to fundamentals and analysis of where we are and has nothing – not nothing, but very little to do with what people in government have to say. All we can do is—

Representative Saxton. Would the gentleman yield?

Senator Bennett. Yes.

Representative Saxton. Maybe that 170 may have something to do with Chairman Hubbard's testimony.

Senator Bennett. I will stipulate to that.

Now, my own sense – and I will just give it to you and get a quick comment. A large part of the stock market tumble has to do with the fact that we were in tulip time. You understand what that means, the Holland tulip bulb and so on, that there were many stocks that clearly had a market cap that was totally unjustified. And people got carried away. And, like every bull market that finally explodes into tulip time, there had to be a correction, and there would have been a correction regardless of what Congress did, regardless of what the President did, regardless of who the President might have been. We would have seen the obscene market caps of some of the dot-com stocks come down to what they were really worth.

And, in the process, the market has overreacted in some areas. It has been exacerbated by the crisis of confidence coming out of the accounting reports so that there is uncertainty about what the numbers mean, but that as soon as that uncertainty passes and the water has been squeezed out of the tulips, the stock market will then begin to respond to the underlying strength and stability of the economy and come back.

Now, is that a Pollyanna view, or is there an economic basis to support that view?

Dr. Hubbard. I don't think it is a Pollyanna view. It is indeed a restatement of market efficiency that we expect stocks to respond to fundamentals.

I would like to quibble respectfully, if I might, with the tulip analogy. I think there are some areas of the market where there may have been some froth, but, broadly speaking, we have seen declines in sectors that were not as subject to that froth.

Senator Bennett. I will accept that.

Dr. Hubbard. So we may be seeing things that are more fundamental having to do with the shifts in equity, risk premia, and the uncertainty to which you refer. But I certainly agree with your summary.

The one caution I would make on policy is there is more that policymakers can do to hurt than to help, in the sense that discussions that generate an atmosphere of uncertainty I think can hang over the market. I don't think policymakers can talk up the market, but I think it can hurt.

Senator Bennett. I accept both your correction and your last comment, that the one thing the market wants more than anything else is a sense of certainty, and they always flee from uncertainty, whether it is caused by a war, or a crazy President, or an out-of-control Congress, or an incompetent Federal Reserve Chair. And hopefully we don't have most of those things. Thank you.

Representative Saxton. Senator, thank you.

Dr. Hubbard, thank you very much for being with us and your time this morning.

Dr. Hubbard. Sure. It is my pleasure.

Representative Saxton. We appreciate it very much. We have not only enjoyed having you here, but we feel we always benefit from hearing your perspective. So, thank you for being with us.

Dr. Hubbard. Thank you. And likewise.

Representative Saxton. We look forward to seeing you in the future. The hearing is adjourned.

[Whereupon, at 11:55 a.m., the joint Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It is a pleasure to welcome Chairman Hubbard this morning before the Joint Economic Committee to testify on the economic outlook.

The economy continues to rebound from the slowdown that began in the middle of 2000, eventually becoming a recession. In March of 2000 the NASDAQ began a sharp decline, with spreading weakness signaled later in that year by falling factory employment and industrial production. The slowdown became a mild recession early in 2001, but economic indicators suggest that a recovery was underway by late last year.

Real GDP increased 6.1 percent in the first quarter of 2002, manufacturing activity rebounded, industrial production rose, and consumption and residential real estate remain strong. However, there are signs that the pace of the economic expansion has moderated recently.

The payroll employment data indicate that many employers have held off new hiring until the sustainability of the recovery becomes clearer. As a result, the output of goods and services is rising, but at a faster pace than is employment. Consequently, labor productivity in the first quarter surged, and is expected to remain strong in the second quarter.

The pace of the expansion may be affected by concerns about international tensions, terrorism and corporate accounting practices. As a result, the level of risk and uncertainty is significant, and this imposes additional costs on the economy and also is reflected in the weak stock market.

As Chairman Greenspan pointed out yesterday, our free market economic system is based on property rights, and "fraud and deception are thefts of property." Reforms are needed in accounting and corporate governance to strengthen safeguards against those who would otherwise abuse the rights of shareholders. The President and Congress are moving forward to provide these needed reforms.

However, despite these problems, the remarkable resilience of the American people and economy continues to be evident. It appears likely that business profits and investment will recover in due course, consolidating and extending the U.S. economic expansion. The Federal Reserve's actions to reduce interest rates, and Congressional actions to reduce the tax burden, have improved the prospect of sustained economic expansion.

PREPARED STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

Thank you, Mr. Chairman. It is a pleasure to welcome Chairman Hubbard of the Council of Economic Advisers. The CEA has a critically important role to play in economic policy. It shouldn't be blind to politics, but it should be above politics in providing the President with the best and most objective economic advice it can.

I am looking forward to hearing Chairman Hubbard's views on the state of the economy, and I wouldn't be surprised if we have some spirited discussion about the Administration's latest forecast and its implications for budget and tax policy.

I have serious concerns about the economic policies that this Administration is pursuing. We are very fortunate that the worst fears about how September 11th would affect the economy were not realized. But I fear that we may be experiencing the same kind of jobless recovery that we saw the last time around, when the recession ended in March of 1991 yet unemployment kept rising until July of 1992 and the federal budget reached a record deficit of $290 billion. Last month the unemployment rate bumped up to 5.9 percent and the number of unemployed people was nearly 2.4 million higher than it was when the recession started. Even though there was a small increase last month, the number of payroll jobs is lower now than it was at the beginning of the year. And, of course, every time we re-estimate the budget deficit it gets worse.

The Administration seems to believe that more tax cuts are the answer. But how do budget-draining tax cuts skewed toward upper-income taxpayers address the concerns of ordinary Americans? People are worried about their jobs and their pensions; they want to be sure that Social Security is on a sound footing and that they can afford prescription drugs; they want to be assured that corporate executives are honest or that they will be caught and punished if they are not; and they want to believe that the government is on their side, working to help them improve their lives.

On another matter, I would like to commend the CEA on its role in improving the quality of Federal statistics. The proposal the Administration unveiled last week to enhance data sharing among the Census Bureau, the Bureau of Labor Statistics, and the Bureau of Economic Analysis is an important step toward improving our ability to measure and understand a rapidly changing economy. The JEC too has had a long tradition of working to improve the quality of federal statistics. In fact, we are having a hearing next week on the topic of measuring economic change, and I look forward to working with the CEA on efforts to create a 21st century statistical infrastructure appropriate to a 21st century economy.

Dr. Hubbard, I look forward to hearing what you have to say about the economic outlook. I hope that the CEA is taking a hard look at economic realities, and can give us some constructive advice on how we

can improve the employment picture while stimulating economic growth and avoiding a new round of ballooning deficits.

PREPARED STATEMENT OF REPRESENTATIVE ADAM H. PUTNAM

Thank you Mr. Chairman for convening this important hearing on America's Economic Outlook and thank you Chairman Hubbard for appearing before this Committee to answer our questions.

I am encouraged by some of the positive economic data that has been released. Real GDP growth is now expected to be 6.1 percent, which is higher than previously predicted. This indicator can provide a boost for our economy because it reaffirms America's fundamental economic soundness.

Nevertheless, risks do appear when one examines the U.S.'s economic outlook for the coming months. For instance, we have all witnessed the massive decline of the stock market and the consequential rapid decline of household equity wealth. Since the end of May of this year we have witnessed the loss of nearly thirteen trillion dollars worth of household equity wealth. This equity has simply vanished. Stability will return when ordinary investors begin to trust the markets and when credibility has been restored to America's financial institutions.

Prospects and risks are present in the current economic outlook but judging by the fundamental indicators such as consumption growth, business fixed investment, productivity growth and GDP among others, economic revitalization can be achieved.

In the past year, the U.S. economy has taken on many difficult hurdles and prevailed. The nagging recession and the economic realties of the war on terrorism has put an extra strain on the U.S economy. Due to the fundamental strength of the U.S. economy an economic rebound will occur. The only question is when and what can Congress do to assist.

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

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

The Economic Outlook

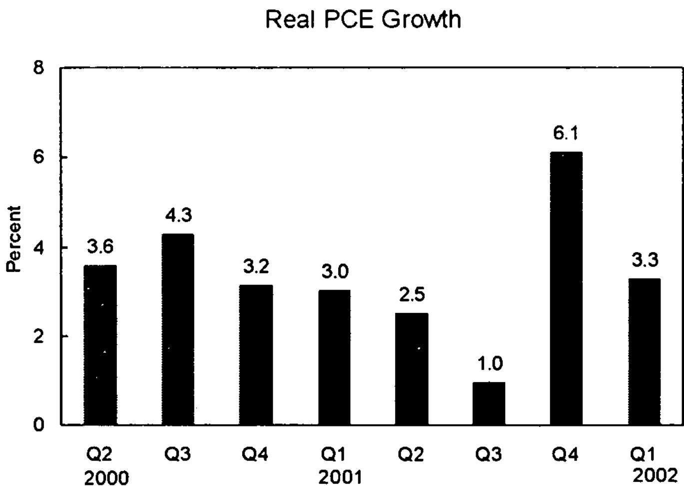
The Administration's economic outlook is contained in detail in the recently released *Mid-Session Review of the Budget*. In these remarks, I will focus only on the main features of that *Review*. The economic assumptions were revised from those used in the Administration's 2003 Budget to incorporate the unanticipated strength and timing of the recovery, as well as the passage of the Job Creation and Worker Assistance Act (JCWAA). Real GDP growth this year is now expected to be considerably higher than anticipated in the Budget, a revision that reflects broad consensus among private sector forecasters.

The rates of GDP growth and unemployment during the second half of the projection period are the same as in the Budget; inflation and interest rate projections are nearly identical to those in the Budget. Specifically, year-over-year GDP growth in 2002 is projected to be 2.6 percent, compared with 0.7 percent in the Budget. Growth during 2002-12 is projected to average 3.2 percent per year – the same rate as in the most recent Blue Chip consensus long-run forecast. During the latter years of the forecast (2008-2012), growth is projected to proceed at the potential rate of 3.1 percent per year.

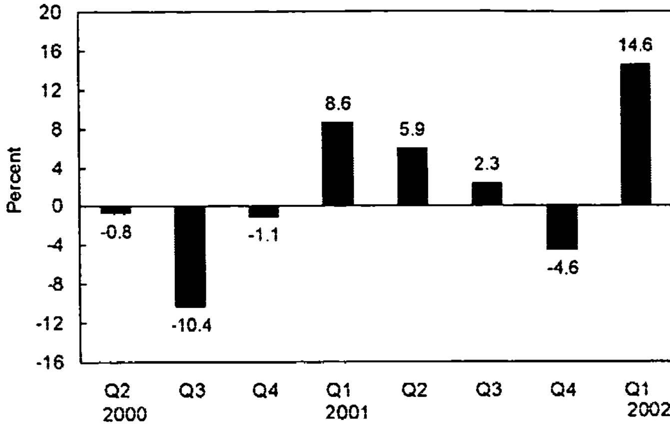
Consistent with the FY2003 Budget assumptions, the unemployment rate is projected to decline during the next few years to 4.9 percent in 2007 and then remain at that low level. That rate is the Administration's estimate (and matches the Blue Chip consensus long-run estimate) of the long-run unemployment rate that is consistent with stable inflation. With regard to inflation, in the near term, the CPI measure of inflation is projected to be 1.7 percent, slightly below the budget projection, while over 2003-2012 the inflation projection is slightly less than 2.5 percent.

The Mechanics of Economic Recovery

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



Source: Bureau of Economic Analysis, Department of Commerce



Source: Bureau of Economic Analysis, Department of Commerce

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

Inventory investment contributed to the economic slowdown, but by early in 2002, the pace of inventory decline slowed, and business efforts to reduce further decline provided a significant fillip to production. In some sectors of the economy,

evidence suggests that inventory restocking is underway. Over the next several quarters, as inventory and sales growth come together, inventory investment's role in real GDP growth should provide momentum. Attention on fixed investment decisions is therefore important.

The key to transforming recovery into robust growth is the pace of business fixed investment. Only with robust business investment will labor markets firm and the economy return to robust job creation. The recently passed "Job Creation and Worker Assistance Act of 2002" (more widely known as the "stimulus

package") reduces disincentives to investment – technically 30 percent expensing. Businesses are permitted to deduct immediately 30 percent of the cost of new qualifying business investments undertaken in the three years starting on September 11, 2001.

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

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

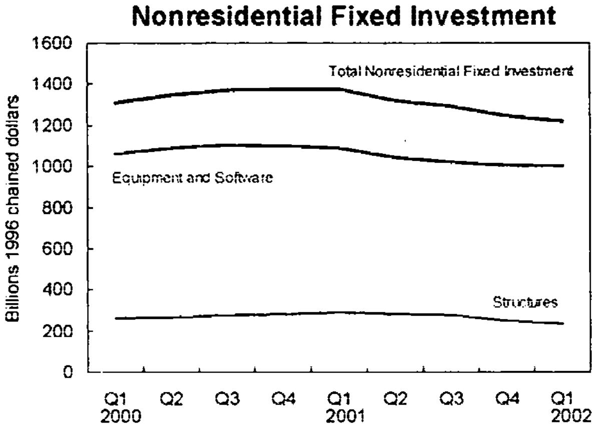
Macroeconomic Advisers June 2002 Investment Forecast
(Q4/Q4 Real Growth)

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

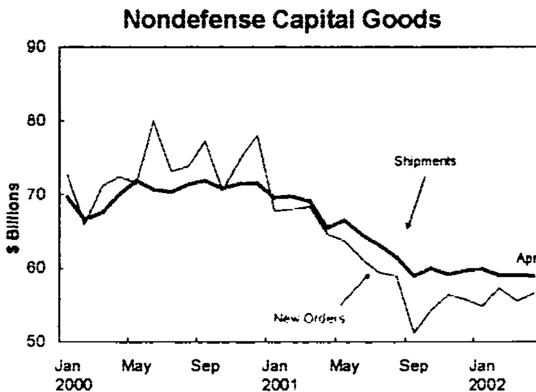
Source: Macroeconomic Advisers June 2002 Economic Outlook

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

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



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



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

Of course, there are risks to this outlook. For example, the stock market has declined about 13 percent since the end of May, reflecting shifts in the equity risk premium and concerns over among other things, profitability and financial data, with the result that household equity wealth has fallen about $1.3 trillion. While this represents a clear loss to households through direct holdings and 401(k) and retirement plans, it has also raised concerns over the durability of the recovery. To get a sense for the potential magnitudes involved, however, begin by noting that consumption tends to fall three to five cents for every dollar of lost equity wealth. In addition, investment also falls because of the higher cost of capital. Combining these effects, a *permanent* loss of 13 percent in stock-market value – together with other macroeconomic interactions in a standard model, including any offsetting action by the Federal Reserve – would reduce the level of real GDP by roughly 0.4 to 0.7 percentage point after one year. While this is a significant impact, but it would not overwhelm the upward path of the recovery. Moreover, the reduction in GDP would be a transitory event, with GDP returning to its former path after three years or so.

Moreover, such an effect would require a substantial (and, as I noted, permanent) loss in wealth and investment incentives. In this respect, it is useful to note that declines in equity values have been offset in part – though certainly not entirely – by increases in housing wealth, lessening the impact on consumption. These recent increases in home prices reflect effects on the demand for housing of low interest rates and demographic factors and have bolstered household balance sheets or, through mortgage refinancing, provided extra funds to finance consumption and debt service. In part due to refinancing, some measures of household debt service burdens have risen;

excluding mortgage interest reveals no significant rise in the fraction of household income devoted to interest costs.

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

Data Sharing Initiative

The intense focus on monthly – or even weekly – data releases during the recovery thus far has focused attention on the importance of improving our economic data. Last week, the Council of Economic Advisers unveiled the President's initiative to raise further the quality of economic statistics. This initiative would remove statutory barriers to the sharing of business data among the Bureau of the Census, the Bureau of Economic Analysis, and the Bureau of Labor Statistics. In addition, it would strengthen the safeguards that protect the confidentiality of the public's statistical information through a clear and consistent set of minimum statutory safeguards and stiff penalties for violators. Enhanced data sharing would improve the reliability and accuracy of key business statistics such as GDP, employment, productivity, and industrial production and would permit the statistical agencies to resolve existing and growing data anomalies that raise questions about the accuracy of economic statistics. For example, GDP has experienced an historically high measurement error approaching $200 billion. At the same time, nearly 30 percent of single-establishment businesses had inconsistent four-digit standardized industry classification codes in the separate business lists maintained at the Census Bureau and at the Bureau of Labor Statistics. This seemingly minor classification issue brings into question the ability to track accurately industry output, employment, and productivity trends.

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

Enhancing Economic Growth

Focusing on the "real economy" my reading of the basic mechanics of recovery and the data thus far indicate a recovery that is roughly on track, with the possible exception of business investment. Of course, it is subject to the standard economic uncertainty regarding fundamentals. However, as you are doubtless aware, there are many news reports focusing on an

uncertain state of economic recovery. To some degree this is surprising in light of my reading of the fundamentals of the economic recovery. Although there are always questions about "when" a particular phase of recovery will transpire, or how strongly a particular component of aggregate purchases may grow, the uncertainty evinced in the public discourse is seemingly far deeper.

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

The deregulation of our economy beginning in the 1970s and 1980s was and is a tremendous source of economic flexibility and success in generating resources for our economy. Deregulation of several key sectors of our economy brought substantial benefits to consumers and workers. One study estimates the combined economic benefit of deregulating airlines, motor carriers, and railroads to be about 0.5 percent of GDP per year.

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

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

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

Marginal rate reductions also improve access to capital and the vitality of the entrepreneurial sector. These impacts are not confined to the income tax. The estate tax acts as a brake on entrepreneurial activity. While entrepreneurs constitute a minority of people, they are three times more likely to be subject to the estate tax, making the tax a drag on asset accumulation and risk-taking in the economy.

Thus one source of uncertainty facing the economy is the specter of failing to make the tax cut permanent, and facing the diminished growth opportunities that would follow. Of course, it is not just an issue of the level of taxes. It is the potential loss of a pro-growth tax policy. Princeton University economist Harvey Rosen has estimated that the marginal tax rate reductions passed in 2001 will lower the efficiency cost – the "deadweight loss" or pure drag on the economy – by roughly $40 billion in 2010. To

put this figure in perspective, note that it is about the same size as last year's tax rebate of $36 billion – and it would happen every year. A manifestation of returning to a less efficient tax system is reduced growth. Professor Rosen's results suggest that doing a U-turn

on taxes would reduce growth by 0.15 percent annually. The basic message is straightforward: Placing the future of pro-growth tax policy at risk raises the level of uncertainty and mitigates against rapid recovery and growth.

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

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

In short, the clash between policies to provide an environment for faster sustained growth and the new orthodoxy has given rise to uncertainty over the future course of policy. Sadly, this clash translates immediately into reduced incentives for growth. In each case, simple action by the Senate – passing TPA or making the tax cut permanent – would remove the lingering uncertainty and raise incentives for growth.

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

An important part of the President's response was a proposal to provide a catastrophic backstop for terrorism risk insurance. The terrorist attacks indicated that the probability of catastrophic property and casualty losses was higher than

anticipated. This situation called for a new policy to encourage private market incentives so that insurers would expand their capacity to absorb and diversify risk—an approach that the Administration proposed.

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

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

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

implementation of its recommendations will serve to reduce the uncertainty stemming from issues of corporate governance.

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

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

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

The private sector has also been active. As noted by Federal Reserve Board Chairman Alan Greenspan, "Corporate governance has doubtless already measurably improved as a result of this greater market discipline in the wake of recent events." One piece of evidence in this regard is the recent

corporate governance rule changes announced by the NASDAQ. Likewise, a committee of the New York Stock Exchange has emphasized the need for reforms of corporate governance.

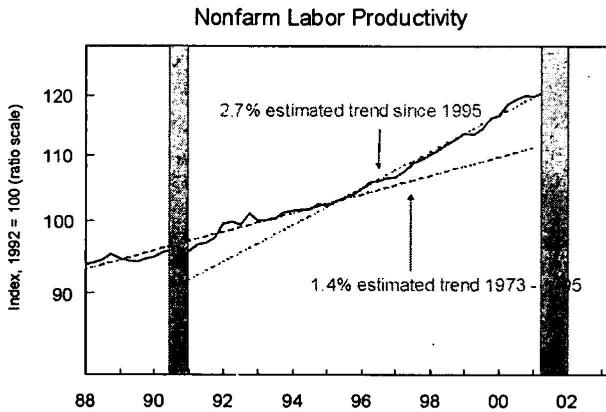
Given the inherent informational advantage of corporate insiders over outside investors, private sector and regulatory reform

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

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

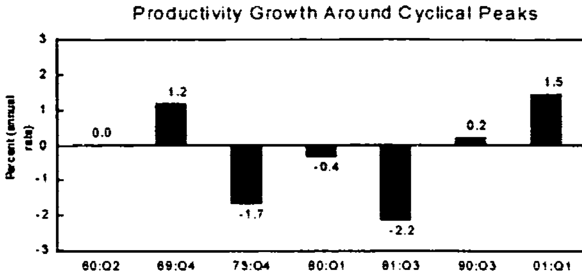
Innovation and Long-Term Productivity Growth

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



Source: CEA calculations.

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



Source: CEA calculations

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

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

Conclusion

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