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THE ECONOMIC OUTLOOK AND TAX POLICY

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED SEVENTH CONGRESS

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THE ECONOMIC OUTLOOK AND TAX POLICY

Wednesday, May 23, 2001

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

The Committee met, pursuant to notice, at 11:00 a.m. in Room 311 of the Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Dunn, English, and Maloney.

Senators Reed and Corzine.

Staff Present: Chris Frenze, Robert Keleher, Darryl Evans, Colleen J. Healy, Brian Higginbotham, Chad Stone, Daphne Clones-Federing, Frank Sammartino, Matt Salomon, and Diane Rogers.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Chairman Hubbard, it is a pleasure to welcome you before the Joint Economic Committee (JEC) this morning. I believe this is your first appearance before Congress as Chairman of the President's Council on Economic Advisers (CEA), and we look forward to your testimony.

The long period of economic growth that began in the 1980s has continued, aside from a short and mild recession in the 1990-91 period. The economic benefits of such a sustained period of economic growth are reflected in the general prosperity and health of the economy evident through the middle of last year. Real gross domestic product (GDP) growth has been strong as labor productivity gains led to higher output and income. Inflation has been reduced by the Federal Reserve, interest rates have trended downward, and rates of unemployment and poverty have fallen over the course of the expansion.

However, as I noted last December, the economy has entered into a sharp slowdown that began the middle of last year. Real GDP growth fell from 5.6 percent in the second quarter of 2000 to only 1 percent by the end of the year. Investment, consumption, and employment have also reflected the sharp slowdown. Manufacturing employment has been declining since July of last year, and employment losses are now spreading to other sectors of the economy.

The Federal Reserve has responded by sharply reducing short-term interest rates and relaxing monetary policy, which began five months ago. I believe the actions of the Fed will significantly improve the prospects for a resumption of healthy economic growth later this year. However, I remain concerned about current economic conditions as reflected in the two consecutive declines in payroll employment. Although I do not believe the tax bill currently under consideration will make the economy turn on a dime, I do think it will have a positive effect over the next year that is much needed for the current economic weakness.

The weak economy is bearing the burden of a tax system that is systematically biased against work, savings and investment, and is literally counterproductive. Real bracket creep gradually continues to push taxpayers into higher tax brackets. The additional burdens of what economists call "deadweight losses" are a significant problem that is not well recognized by many policymakers.

Essentially, deadweight losses arise because the tax system imposes added economic costs in addition to the revenues raised by taxation. In other words, for every incremental dollar raised in revenue, the tax system imposes other costs amounting to 30 or 40 cents on the economy. Thus, each dollar in tax reduction can provide significantly more than a dollar in benefits to the economy. In my view, this is a key reason to reduce the burden of our counterproductive tax system.

Fortunately, progress is being made on a bipartisan tax bill to reduce the tax burden on the U.S. economy. It will not solve all of our immediate problems, but it will improve the prospects for healthier economic growth in the years ahead. The stronger economy will in turn help us to address the long-term economic and budget challenges faced by our Nation.

We have a tremendous opportunity to enhance the economic future of America by reducing the weight of our counterproductive tax system.

[The prepared statement of Chairman Saxton appears in the Submissions for the Record on page 26.]

Representative Saxton. I would like at this time to ask Mrs. Maloney if she has any opening comment, and then we will turn to Dr. Hubbard.

OPENING STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Representative Maloney. Thank you, Mr. Chairman. I understand Ranking Member Reed, Senator Reed, is on his way, in between votes in the Senate, but I do want to thank you for having this hearing today on the state of the economy, and it is a particular honor to welcome Dr. Hubbard. As a New Yorker, I understand he served at one of our great institutions, Columbia, before joining the administration.

As we have seen since the middle of last year, economic growth has slowed dramatically. The manufacturing sector has lost over a million jobs. Only continuing strength in the service sector and strong household spending have kept a recession from spreading throughout the economy. Unfortunately, recent signs are cause for concern. The recent sharp rise in the unemployment rate and the potential impact of high energy prices on household budgets could lead to increased economic difficulty. The current administration's one-note answer to all these problems has been its tax cut proposal. While I am personally certain that Congress could pass a historically large, responsible tax cut on a bipartisan basis, the bill that we will vote on later this week is no such agreement. I believe the tax proposal risks a return to deficits and it is fundamentally unfair to lower-income workers and to my State of New York.

As introduced, the Bush tax bill was so large and based on economic assumptions that can vary so greatly, that we risk deficits if our numbers are only slightly off. The Senate bill is only marginally better. The Congressional Budget Office (CBO), whose rosy projections are the basis for the tax cuts, indicated that its average error margin in projecting budget surpluses or deficits for the fiscal year in progress has historically been about 0.5 percent of the GDP. In the current economy, this would be roughly $54 billion in one year.

As for projecting five years out, CBO's average error has been 3.1 percent of GDP, a sixfold increase. Many of the Bush tax cuts do not fully phase in for 10 years in order to hide the tremendous cost. To borrow a Bush catch phrase, using CBO projections passed on continued strong economic growth for the next 10-years is truly "faith-based" budgeting.

While the tax cut itself is large, it is not so large that it provides relief to the lower-income Americans who pay the majority of their taxes through payroll taxes rather than income taxes. Ironically it is these Americans whose household budgets are most affected by rising energy prices. While President Bush has suggested that the tax cut be enacted to pay for skyrocketing energy costs, his plan does not benefit these very workers.

Finally, the tax bill on its face is fundamentally misleading. Provisions granting marriage penalty relief and estate tax repeal are so costly that they do not fully phase in for a decade, well after President Bush's return to Texas. The full force of these provisions will confront the country just as the baby boom generation increases its reliance on Social Security and prescription drugs.

Most misleading about this tax bill is the way it treats taxpayers with similar incomes far differently, based on the state in which they reside. This is because it greatly increases the impact of the alternative minimum tax (AMT), which reduces deductions such as state and city taxes. The nonpartisan Joint Committee on Taxation estimates that our current tax code will push 20 million taxpayers into the AMT over the next 10 years. The Bush plan increases this number to 35 million. This impact is not news to the Bush administration. The President knew when he introduced his plan that the $1.6 trillion in tax cuts was not, quote, just right and that an AMT fix is necessary. Signs from the administration and Congressional leadership are that any such fix will only be included in the next tax bill. No doubt this next tax bill will also be loaded with other provisions.

I do not believe this is a responsible way to pass a tax cut or a budget that has yet to take into account the defense review. The administration has argued that their tax bill will boost the struggling economy. At the same time, they say that the economy is strong enough that a large tax cut is not fiscally irresponsible. I am afraid that they have missed both targets. Thank you, Mr. Chairman.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 28.]

Representative Saxton. I thank the gentlelady. Let me just do two things, if you will bear with us for a moment, Dr. Hubbard. Let me welcome Congresswoman Jennifer Dunn to the Committee, her first hearing with the Committee. We are really pleased that you are with us and we look forward to a very productive time here this year and the next on the Joint Economic Committee.

Also, Senator Reed and Senator Corzine have come over from the Senate. We know that you have a very busy schedule today and that you may have to leave us for votes, and so at this point, Senator Reed would just like to say a word and, I believe, ask that his statement be included in the record.

Senator Reed. Thank you, Mr. Chairman, and thank you, Dr. Hubbard, for joining us this morning. As the Chairman indicated, we are in the midst of a debate on the tax bill. We will have to leave momentarily, but I do want to submit my statement for the record and also yield to Senator Corzine for a moment if he has a statement that he would like to put in the record.

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 30.]

Senator Corzine. It is great to be here and I appreciate, Mr. Chairman, you holding this hearing. I had an opportunity to visit with Dr. Hubbard personally, and then also at the Banking Committee hearing. I think all of us have many questions with regard to the economy and the impact of the tax program on it, but he is a very worthy commentator and participant in this process. Thank you.

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

Senator Reed. Thank you, Mr. Chairman.

Representative Saxton. Thank you.

Dr. Hubbard, welcome to the Joint Economic Committee. We are very pleased that you are here and we, without further ado, would like to move on to hear your thoughts as you care to present them.

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

Dr. Hubbard. Thank you, Mr. Chairman, and Senator Reed, and Members of the Committee for inviting me. I hope this will be the beginning of a dialogue between the Council of Economic Advisers and the Committee, both on the current outlook for the economy and where economic policy stands.

Mr. Chairman, you already gave a quite nice view of the economic situation. I will be comparatively brief in my own version of events in the testimony, and then I wanted to spend some time talking about the President's proposals.

I think the backdrop of the current situation traces, exactly as you noted, Mr. Chairman, to the long boom that goes back to the early 1980s.

I think it is, of course, first and foremost, traced to efforts and innovation and activity in the private sector but also to responsible public policy. The Federal Reserve's actions to contain inflation and bring down the rate of inflation acts as a very large tax cut on investment and contributes greatly to the economic stability that we have seen.

Second, we saw in that long boom period generally favorable developments in tax policy, with the exception of the early 1990s. We saw reduction generally in the level of marginal tax rates.

And third, a broad deregulation of commercial and economic activity that allowed incentives in the private sector to promote growth.

In this period we have seen fairly substantial improvements in GDP growth, investment, and productivity. Those had accelerated prior to the recent slowdown during the course of the late 1990s. And of course, as I have indicated, all of these accomplishments in the real economy have also coincided with a period of low inflation, suggesting their sustainability.

Now, of course, more recently, commencing around the middle of the year 2000, we have seen a growth slowdown. I like to refer to this as an unacceptably slow rate of growth, because the rate of growth the economy has been experiencing is dwarfed by its potential rate of growth. Hence, it should be unacceptable to all of us.

The peak in the conference board's index of coincident indicators, which you can think of as kind of a snapshot of the current situation in the economy, occurred in September of 2000.

Now, despite this deceleration in the rate of growth, we are not now, in my opinion, nor are we likely to be in a recession. So we have seen a growth slowdown, a growth slowdown that is painful to all of us, but I don't think portends a recession.

The May Blue Chip Consensus Forecasts, produced by professional forecasters, has real GDP growth at around 2.2 percent for year 2001, accelerating to 3.4 percent in 2002.

Now, why are we in this position of a growth slowdown when we had a period really of almost unparalleled prosperity? Where are the pressures coming from on the economy?

First, on the consumption side, consumer spending has been relatively resilient in this growth slowdown. It indeed is probably responsible for why we have not seen worse. There are reasons to still be concerned. The wealth effect in consumption – that is, the effect of declines in equity values and consumer spending – occurs with a lag. And consumer confidence, while rebounding a little, is still relatively shaky.

On investment, we have of course seen declines in overall business fixed investment over the past two quarters. There are bright spots. Construction investment, for example, is up sharply. The sector that we all know has been hit most significantly – and is especially important because of the attention paid to the new economy – is information technology equipment. It is my own view that we should see a rebound in IT, information technology equipment spending, toward the end of this year and into next year, conditional on the fiscal stimulus that is being debated, being in place. I say this in part because depreciation of this equipment is relatively rapid.

There are those, to be candid, who would indicate that current weak profits might portend a longer period of a adjustment in the IT sector. But even that view indicates that the downturn works through in about a year.

Another factor that has already come up this morning is the role of energy prices. The easiest way to think about the run-up in energy prices over the past two years is that they function as a kind of tax on consumers and on firms. It is a tax that has contributed to the growth slowdown in the economy.

In terms of the rest of the world, certainly the weak growth in the short term in the U.S. economy has been exported abroad; that is to say, the weakness in the U.S. has not been good news for our trading partners, and at the same time, weakness abroad has restrained growth a bit in the U.S.

With all this discussion of the short term, in the description of economic outlook, I want to be sure to leave with you what I think most economists would tell you: that the long-term outlook for the U.S. economy is very bright. The improvements in living standards that we all seek for our country are reflective of productivity growth, and most of the estimates for long-term productivity growth that underlie everything from the long-term budget forecast that we debate and the long-term forecast of our own living standards as Americans, are still very good.

There is, however, a caution in that statement. I use it as a segue to talking about economic policy as opposed to the current outlook. Current productivity growth does not happen in a vacuum. It is dependent, really, on at least two very important things: one, the continued pace of innovation and entrepreneurial activity in the private sector and two, sound economic policy and public policy.

So, while I think that outlook for productivity growth is bright, it does not mean that it is invariant to whatever policy we might pursue.

Now, to discuss the impacts of the President's proposals, I think it is important to revisit the setting of the President's tax plan. I had the privilege of working with the President quite a bit, on the tax plan during the campaign and, as you well know, the setting at the time did not require talking about economic stimulus. Indeed, a principal reason for the President's consideration of sharp reductions in marginal tax rates was the rising tax share and income tax share due, in particular to the phenomenon of real bracket creep.

To be concrete, if you look at the first half of the 1990s, between 1990 and 1995, about 8.1 percent of GDP was paid in individual income taxes each year. By the year 2000, closing the decade, that ratio had risen to 10.2 percent, which was an all-time high for individual income taxes. Absent law changes, that share will continue to grow.

This is not fiscal drag in the usual sense– automatic stabilizers in a budget that in good times collect more and in bad times collect less. This is a structural issue attributable to real bracket creep. While we have indexed brackets in nominal terms, as we have seen improvements in real growth, thank goodness, the progressive tax system is a very powerful machine for raising the growth of the public sector.

With the President's tax plan, part of this growth, although by no means all of it, would be attenuated.

A second issue that the President spoke about repeatedly in the campaign, and he has repeatedly used in advancing the tax bill with the Congress, is that high marginal tax rates aren't just about budget numbers or tax shares. They are about discouraging, as you put it, Mr. Chairman, work and saving and entrepreneurship, and in this setting it is important to think about potential stimulus effects of a cut in marginal tax rates.

First, the announcement of a permanent cut in marginal tax rates is, in and of itself, stimulative. If you were to query any of a number of forecasters in the private sector, or academics who look at more longer-term models, you would get very large effects on economic activity of a large, believable, permanent cut in marginal tax rates.

A second source of stimulus that is now being discussed, is related to the President's call for an acceleration of the tax cut to deal with the short-term growth pressures – an up-front stimulus. But I think it is important not to lose sight also of the big-picture effect of cuts in marginal rates themselves.

A third area of interest and importance to the President in the tax plan is that while marginal tax rates are to be cut, there should be no damage done to the fairness of the tax system. The largest percentage of tax cuts go to individuals at the bottom, not the top, of the income scale.

It is often thought that high marginal tax rates are a problem of the rich or of high income, but there are high marginal tax rates at many points in the Internal Revenue Code, something you all know well. Many low-income households, and secondary earners deciding to work, and other situations face high marginal tax rates. This is not a rich person's problem.

Now, one of the great frustrations, I think, in the current debate, is I think too little attention is being paid to the economic impacts of the tax plan; not just the President's proposal, but what is being debated currently on the House and Senate side. The President's plan focuses on reducing marginal tax rates, and any bill that comes out, I am sure, will have that focus as well. There is by now a very large body of evidence among economists that improving marginal incentives, that is, rewards to effort, to investment, to innovation and a variety of other activities, is the key.

Now you mentioned the concept of deadweight loss, Mr. Chairman. It always warms an economist's heart to hear words like deadweight loss, but I think the simple way to think about it is as pure waste. As we think about a tax system, we don't want a tax system which is, in effect, throwing away economic resources as it collects money. And the 30- to 40-cent waste to which you referred, Mr. Chairman, is a real economic cost of high marginal tax rates.

Without boring you with formulas, suffice it to say that as you cut marginal tax rates, you are getting a more than proportional reduction in the waste associated with the tax system. Conversely, if we were thinking about raising marginal tax rates, the waste would increase faster than the rate of increase of the tax.

Now, what is the visible benefit of this reduced waste beyond economists muttering? One is participation in work effort for low-wage workers. There is a quite significant literature in labor economics suggesting both participation and hours responses to cuts in marginal tax rates for low-income Americans.

Second is secondary-earner effects. The decision to participate in the labor force and how much to participate of secondary-earners, is quite responsive to tax changes. And so again, there is very large waste associated with high marginal tax rates on secondary-earners -- the so-called marriage penalty issue.

A third area of interest lies in entrepreneurship, and the growth of business clearly is a big factor in the innovative boom that we have seen. To be concrete, if we were to reduce the top rate from 39.6 percent to 33 percent, say, it would raise by most economists' estimates small business capital outlays by about 12 percent and small business payroll growth by four percent.

Now, there are two ways to think about statements like that: one is sort of an "econ-speak" of thinking about elasticities of responses. But there is a far more important way to think of it. When we are thinking about reducing the top rate on business people – who are, by the way, more than half of the top-rate filers – the issue is not so much what is the effect on the tax bill of that businessperson, but the spillover effect to suppliers, investment in capital, and employees. So this is a very big deal indeed.

As regards the top rate, there is again quite a large literature among economists of effects on incentives broadly; not simply entrepreneurship, but risk taking, financial engineering and so on, that has been summarized by the induced increase in taxable income. Perhaps the most prominent of these studies is by Martin Feldstein, who is a predecessor of mine as Chairman of the Council of Economic Advisers. He found very elastic, very large, responses of taxable income to changes in the top rate. This reflects two things that are of interest to all of us. One is this waste point that the Chairman wisely raised, but also the issue of revenue. It reminds us that as we cut taxes, part of this revenue comes back to us in the term of increased taxable income.

Now, how does the President's plan measure up against these goals? First, there are broad-based cuts in marginal tax rates. Second, the plan would eliminate the death tax, which is a tax that is tied to capital accumulation. Third, by permitting non-itemizers a charitable deduction, the plan bolsters the role of the not-for-profit sector in the economy. Fourth, as regards human capital, expansions in the child credit, marriage penalty, and education savings accounts are important. And, finally, on technology, the proposal by the President to permanently extend the R&D tax credit will be very beneficial.

Let me give you a quick bottom line. I think it would be fair to say that almost any economist that sat before you today would suggest quite substantial effects on economic growth of the President's tax plan. There are two ways to see that. One would be in short-run, macro-econometric models that you often see brought to you as evidence. Those models would have an effect on aggregate demand growth over the next few years, probably in the four-tenths of 1 percentage point range. I think that estimate understates the long-term effect of the President's plan. Most of the work on longer-term models of capital accumulation would give you a still greater result.

The other bottom line that I wanted to leave you with is an admonition about uncertainty. It is the case that forecasters in the private sector have already taken a fairly significant tax cut to the bank in their forecasts. Consumers and firms, in making decisions about confidence, have taken into account a large tax cut. Uncertainty over the likelihood of the tax cut, uncertainty over the phasing in of provisions, let me be perfectly clear, has fairly significant negative consequences for the recovery.

So thank you again, Mr. Chairman, for giving me this opportunity to talk with you today about the state of the economy and the President's proposals for long-term economic growth, and I would be delighted to answer any of your questions so far as I am able.

[The prepared statement of Dr. Hubbard appears in the Submissions for the Record on page 34.]

Representative Saxton. Dr. Hubbard, thank you very much. Let me just say at the outset that over the past six and one half years, during which period I was first Vice Chairman in 1995-1996, Chairman in 1997 and 1998, and then Senator Mack was Chairman, in the ensuing two years, and now, I have the privilege of being the Chairman again, we have tried to define our mission rather specifically; and that is, to see what is going on in the economy, and then to try to determine what it is about Federal policy that is having an effect on the economy, positive or negative.

And so to that extent, let me just ask some questions. First of all, you mentioned that until the end of the second quarter of 2000, the economy seemed to be doing very well, as a matter of fact, and you mentioned a period of 17 years or so of economic growth with one short mild recession in1990-1991. But then the beginning of the third quarter of 2000, or during the third quarter of 2000, real GDP growth, which had averaged about 6 percent during the prior four quarters, fell to an average of about 1.7 percent during the next three quarters. And, similarly, consumption slowed beginning in the second quarter; also, investment growth shows a very similar pattern. Gains in employment also declined significantly after mid-year of 2000. Manufacturing employment decreased significantly during the second half of the year. Industrial production also slowed during the same time frame, falling seven months in a row as a matter of fact, and eight of 10 months since June of 2000.

Clearly, this is evidence of a slowdown of significant nature. Would you agree with that?

Dr. Hubbard. Certainly we have seen a quite significant growth slowdown. I definitely agree.

Representative Saxton. Also, given the economic slowdown that clearly developed last year, what do you think were the principal economic causes or explanations of the slowdown?

Dr. Hubbard. As with most slowdowns, there is no smoking gun. There is no single force, but rather a number of forces acted to slow the economy. The decline in equity prices impacted both consumer spending and investment. The increasing perception that there might have been some excess investment in the information technology equipment sector hurt investment in that sector. Energy prices acted as a brake both on consumer spending and investment spending, and, of course, there were delayed effects of monetary policy actions as well. All of these factors contributed to the slowdown; along with, of course, the fiscal drag that had been built into the tax system.

Representative Saxton. Given what you see as the causes, do you expect this slowdown to be rather brief or more protracted? What do you think, will happen?

Dr. Hubbard. I think the growth slowdown is likely to be brief, but this view is contingent on observations about policies. To be specific, I think that the recent Federal Reserve policy action will begin affecting the economy quite vigorously toward the end of the year, and, should the Congress pass quickly a tax cut and it goes into effect relatively quickly, that will also be affecting aggregate demand toward the end of the year. So I think, conditional on those policy responses, we will see a response of the economy at the end of the year and into 2002.

Representative Saxton. With regard to Federal tax policy, isn't it true that there is an additional effect, which I referred to in my opening statement, and that you referred to also in your statement, that economists refer to as deadweight losses, which means that the actual loss on a dollar-for-dollar basis is larger in the economy than the actual dollar of taxes that is paid or taken out of the economy and put into the public sector?

Dr. Hubbard. That is correct. That loss comes from a variety of factors. I referred to it as waste, because it is individuals curtailing effort they might otherwise have made, or entering unproductive transactions that they might otherwise not have; and, as you noted in your remarks, most of the estimates are on the order of 30 to 40 cents on the dollar. For some taxes the waste is even larger.

Representative Saxton. Is this a broadly accepted notion in economics generally?

Dr. Hubbard. The idea of deadweight loss is universally accepted as one of the effects of taxes on the economy. In terms of empirical evidence of deadweight loss, there are ranges of estimates. but the 30-to 40-cent range is toward the midpoint of those estimates. There are certainly estimates that would be many times that large.

Representative Saxton. So in considering tax policy, would it be prudent for Congress to take into consideration this waste or deadweight loss that you are discussing?

Dr. Hubbard. I think it would be entirely appropriate to do so, Mr. Chairman. in the form of impact statements, if nothing else, that would go along with standard revenue scoring and distributional analysis.

Representative Saxton. This subject seems to have been strangely absent from the debate in this Institution and in the Senate as well, and it seems kind of strange to me that we haven't talked about this more. We talked about it in previous administrations. And I am just curious, have you heard much discussion on this topic?

Dr. Hubbard. There was an effort a few years ago by the Joint Committee on Taxation to explore some of the concepts. But you are right, there has not been much effort in recent years. I think that the Treasury Department remains interested in bringing together academics to work with the Treasury on this subject, and my hope would be that the Joint Committee would feel the same way.

Representative Saxton. And you, I believe, made reference in your opening statement that the current tax package under consideration would have some long-term economic effects partly, or maybe largely, because of this concept. Is that right ?

Dr. Hubbard. The effects would be twofold. One would be genuine effects on real economic activity, which is why, of course, we are talking about the tax bill. The other effects are on taxable income and have to do with the way individuals arrange their affairs and the effort that they make.

Representative Saxton. Would it be fair to say that a key reason for tax cuts would be to reduce deadweight loss?

Dr. Hubbard. I think that is a key reason to focus on marginal tax rate cuts. The reason the President focused on marginal rates was that he thought those were the most efficient ways of recycling money to the American taxpayers.

Representative Saxton. Well, thank you. I think it is an extremely important concept and one that we have worked with, I think, in a very significant way over the last decades. And I thank you for being here to discuss it with us morning.

Mrs. Maloney.

Representative Maloney. Thank you, Mr. Chairman. Senator Reed and Senator Corzine have inquired if they would be able to place their questions in writing and have them—

Representative Saxton. Without objection.

[The questions of Senator Reed, along with the responses from Dr. Hubbard, appear in the Submissions for the Record on page 44.]

Representative Maloney. Dr. Hubbard, in your statement you focused a great deal on the marginal rates. And what evidence is there that the tax cuts will boost economic growth? How can anyone argue that marginal rates hurt productivity, given the extremely wonderful expanding economy, the best economy in my lifetime, that we have experienced in the last years. And this expanded with the marginal rates. So what proof is there that cutting the rates are going to expand the economy? The economy slowed down particularly during this debate when we have been talking about cutting marginal rates.

Dr. Hubbard. You have really asked two questions. I will take them in turn. The first question is what do we know about the effect of marginal tax rates on the rate of economic growth. There is a large body of research that suggests high marginal tax rates discourage labor supply, hours worked, savings decisions, investment, and entrepreneurial decisions. I think that is a fairly uncontroversial statement.

Representative Maloney. But for the past eight years we had these marginal rates, and it was the best economy in my lifetime.

Dr. Hubbard. Right, exactly. Your second question is a difference between moving along a curve and shifting a curve. It is a classic issue. The question is what are you holding constant? It is true that we had a number of strong tail winds in the U.S. economy that were very positive over the past decade. The point is if one controls for those, as a number of these empirical studies do, there is still a deleterious effect on effort and entrepreneurship and activity. So the right counterfactual is: controlling for those positive forces that we did see? What could we have seen? We could have seen even more. As the economy begins to weaken, those forces become in greater relief. So I take your point that the 1990s were very good economic times, but I think most economists believe they could have been even better.

Representative Maloney. Well, I would like to question it and focus on the sharpening of the yield curve. Long-term rates are rising, yet the Fed has been cutting rates, and yet the long-term rate has risen roughly 1 percent. I mean, that is like a hidden tax on everyone when these rates rise. And couldn't this be interpreted as a lack of trust, shall we say, from the markets with this huge projected tax cut that could put us back into deficits and other economic challenges, shall we say?

Dr. Hubbard. That is not how I would read it. I would read the uptake as reflecting improved prospects over the long term for the economy and for credit demand. I don't think you would find too many Wall Street economists worried about the long-term fiscal position of the government at the moment especially in setting long-term rates.

Representative Maloney. But the long-term yield going up, the rate going up 1 percent, I think most economies would be worried about that.

Dr. Hubbard. Again, rates are prices and reflect supply and demand. So the question is: why does the rate go up? The two principal reasons one would think about the long-term rates going up would either be inflationary expectations, which appear to be quite modest, or increases in credit demand. I think that's where most of the attention has been.

Representative Maloney. I would like to go back to 1990 and 1993. There were dire predictions that tax rate increases would cause an economic downturn. Yet we got just the opposite. And isn't growth more likely in our economy if the government follows a prudent fiscal policy of paying down the debt? Paying down the debt really lowered the rates on all Americans for interest rates, mortgage payments, rates on cars, which in a sense was a tax cut to all Americans. And isn't growth more likely if we continue a strong policy of paying down the debt?

Dr. Hubbard. Your question raises a very important point, which is what is the gain to the economy of cutting marginal tax rates as opposed to doing other things with the surplus – paying down the debt comes to mind.

I think you are absolutely right that a sound fiscal policy is important for economic growth. I think it contributed to the long boom. I would question the premise that the alternative to cutting marginal tax rates in the current environment is simply paying down the debt. I don't think we have seen the fiscal restraint on the spending side that would be associated with paying down the debt. So I think that getting the money back to the taxpayers would be more salutary than simply spending the surplus, which I see as the other alternative.

Representative Maloney. Because so much of the administration's and the House and Senate's tax cut proposal occurs in the second half of the 10 year projection period, it is clear that the cost of the tax cut of the second 10 years is much higher than estimates in the first. Some estimates suggest that the cost will be almost twice as high, yet it is during the second ten years that the budgetary pressures of the baby boom retirement will hit with full force. And isn't the large tax cut proposed by the administration fiscally imprudent in the face of the budgetary pressures that we know we are going to confront in the next ten years?

Dr. Hubbard. Well, the short answer would be I don't think so. I think most people who have looked at the out-year or, quote, steady-state cost of the tax cut still think that it is quite affordable, again conditional on the productivity growth forecasts.

You raised a very important point, however, about long-term pressures on the budget that come from entitlement programs. The President has been quite focused on directing the Social Security Commission to report back to him on reform of Social Security. I think you are absolutely right to highlight those pressures.

Representative Maloney. In your prior statement you talked about that you thought if we spent the surplus, this was not a good thing to do. Yet government spending as a share of GDP has been falling and democratic budget proposals have called for smaller tax cuts and more debt reduction, and government is not consuming a rising share of resources. And so my question is: What has been happening to Federal spending as a share of GDP? It has been falling, which is counter to what we said we would be doing.

Dr. Hubbard I think there are two points in question, one is on debt reduction. Of course, under any of the plans that you are considering on either side of the aisle, there is an enormous amount of debt reduction because of the dedication, wisely so, of Social Security surpluses to Social Security.

Let's be clear, there is an awful lot of debt reduction. My comment on spending had to do with observations of recent increases in the number of proposals for, and, the rate of growth of, discretionary spending, which would likely not have happened had there not been a such a surplus to fund that spending. Going back to what I had said before, I don't think the statement of debt reduction is necessarily the correct premise in the current budget environment.

Representative Maloney. Along with preserving Social Security and tax cuts and so forth, but isn't it somewhat of a scare tactic to talk about rising spending when that is not the case? Government spending as a share of GDP has been going down in both the Democratic and Republican plans.

Dr. Hubbard. It is not an issue of a scare tactic so much as asking: when we have this great opportunity created by the private sector for – this surplus – what do we do with it? What is the most efficient? And I think that among the three choices – tax cuts, debt reduction, and spending increases – probably most economists would put spending increases third of the three.

Representative Maloney. Well, that is the Democratic proposal; a third for spending, a third for tax cuts, and a third for paying down the debt.

Dr. Hubbard. When I said "third," let me be more clear. I meant the bottom. In terms of priority ordering, I think most of the evidence would say we get the largest efficiency gains from cutting certain marginal tax rates where they are high, a la the President's proposal; second, the debt reduction that is being done via Social Security; and then spending increases only where the payoff is high – for example, the President's educational proposals.

Representative Maloney. Well, the Chairman has indicated my time is up. Thank you. Thank you, Mr. Chairman.

Representative Saxton. Thank you.

Ms. Dunn.

Representative Dunn. Thank you, Mr. Chairman, and I am happy to be a Member, a new Member of your Committee, and glad to have the chance to listen to you, Dr. Hubbard.

I have a few questions for you. During the most recent debate over President Bush's tax plan, some of us, some Members of Congress, including myself, became very distressed at the effect of the scoring system that we have in the Congress of the United States. Some of the cost estimates that were provided to us by the Joint Committee on Taxation, for example, seemed very overblown in certain cases, and in other cases failed to take into account the positive effects that might occur among some of the results on the tax plan. For example, when we dealt with changes, potential changes in capital gains rate reductions and changes on the death tax repeal bill, none of the unlocking of assets was taken into consideration, and yet other omissions from the income tax as a result of taking away the gift tax were considered as a negative effect.

As you talk about deadweight losses, the compliance costs when you are dealing with preparing for a death tax bill seem to me to be an example that the scoring system should have taken into consideration, because those would be dollars in a year that would be left in the economy instead of pulled out to purchase estates and that kind of thing.

I would like to know about your opinion about the efficacy of dynamic scoring and I would be interested in knowing whether this administration has any plans to target our scoring system so that we can be far better informed, particularly since we seem to be estimating in 10-year numbers of years, a tough way to estimate. More importantly, how can we encourage government economists to pursue more realistic assumptions, economic assumptions?

Dr. Hubbard. Those are all great questions. On the Joint Committee staff and the Treasury staff, I think you have very talented economists who are playing by what is perceived to be the rules of the game. The death tax, for example, is an area – as you know better than anyone in this room – that has a lot of complications. And there I share your concerns with some of the estimates we have seen on the death tax. As to the larger question of dynamic scoring, during the campaign, President Bush always used static numbers. There was no attempt to engage in dynamic scoring, and the administration in presentation of the first budget has not done so.

Having said that, we think that the Congress and the public would be better informed if information about the impact of major tax changes – not every small change, but major tax changes like the bills that are being discussed now – had an economic impact assessment. I think we would encourage the Treasury in-house, and also the Joint Committee to think about providing that information. Whether it is done formally as a part of the scoring process depends on your requests of the Joint Committee. But I think as Members, you deserve that information in your deliberations.

Representative Dunn. I appreciate that attitude because I think we are ending up with some assumptions that are based on incorrect information as we take a look at the costs of some of these tax bills over the short and the long-term.

I read recently an article in *The Post* that stated according to IRS data, the highest-earning 400 Americans paid as much income tax as the lowest-earning 40 million Americans.

Critics of the President's tax plan claim that the rate reduction is skewed toward the wealthy and will erode the progressive nature of the Federal income tax.

Dr. Hubbard, would you elaborate on the progressivity that is found in the President's plan; for example, the estimate that six million people will be taken completely off the plan and that a single mother of two children can make up to somewhere around $31,000 in income a year before she will begin to pay the income tax.

Dr. Hubbard. Sure. You have already given two very good examples. I think more generally it is important to look at the tax system we have right now, a system that is collecting the bulk of the income tax from very high-income taxpayers. As it stands under current law, individuals at the top of the income distribution are carrying the vast bulk of the tax system. Just by arithmetic, any changes that were across the board in marginal tax rates would give a large share of a tax cut to those individuals.

That is not how we typically think about progressivity. Basically we would want to compare the difference between the share of taxes being paid in the old system, what we have now, with the share of the cuts in the new system. The proposal by the President, and the versions you are considering in your deliberations, are progressive – the very high-income taxpayers receive a smaller share of the benefits, of the cuts, than they have as a share of the taxes paid now. So I think you are quite right.

Having said that, there will be claims – which are true – that the largest shares of the tax cuts go to high-income people. But, again, that is because they are the ones paying the taxes.

Representative Dunn. I think that is a point that is missed a lot of the time. I think the fact that this is a tax relief program for people who pay income tax, and obviously people who are higher-income earners are going to pay more, they are obviously going to get more dollars back, but the share they get back is, in fact, less than the share of the lower-income earner.

Dr. Hubbard. That's right. And your question makes the important point that this isn't an across-the-board cut in marginal rates. The largest effective cuts in marginal rates are for low-income households, not for high-income households.

Representative Dunn. Let me ask you an energy question. As you are aware, my part of the country, the West, is experiencing an energy crisis. I would call it that. I am representing a district where costs are beginning to go up on energy prices and I suspect that this will spread eventually. The President has responded with a long-range plan that differs or that offers a balanced menu of solutions.

In your written remarks, which I thought were excellent, you briefly mention energy prices and how they relate to the economy. Could you please expand a bit on your remarks that you had in your written statement? In your estimation, for example, how will the energy crisis affect the economy in the short-term and in the long-term? Should it be considered a regional problem or a national problem? And lastly, I would be interested in your thought on the effects of price caps on energy supply.

Dr. Hubbard. Sure. As to the three questions, let me first discuss energy price increases in the economy. Energy price increases have had a negative effect on the economy in the past two years. I gave you, I think, a calculation in the testimony that was drawn from an International Monetary Fund study that indicated it was about four-tenths of a percentage point on the growth rate of GDP.

I think, however, there is a tendency to focus in those types of calculations on simply prices of inputs, like crude oil or natural gas. What we will see a bit this summer and what we will continue to see, absent action, is a deficit in our Nation's infrastructure for energy both on the electricity side in power generation, and on the petroleum side in oil refining. We have not had the investments that we need in those sectors and we are, frankly, going to experience capacity problems even if crude prices, and raw material prices, come down.

So what we see as regional problems, I don't think are regional problems. I think they are a national policy problem. I think in the energy policy report that the President submitted, he outlined a number of excellent suggestions both in refining and electricity.

On the question of price caps, price caps are simply bad policy. And the way to see this is to think about the problem I just mentioned: we need improvements in electricity generating capacity, and new infrastructure investments. Picture yourself as a businessperson. If I say I would like you to make this very long-term investment, but, oh, by the way, if times are good I am simply going to take the profit, and if times are bad it is your problem. Now, what kind of long-term investment decisions do you think we would observe? I think price caps are exactly the wrong answer, and I think condemnation of price caps reflects not at all a lack of interest in the problem, but rather a big interest in the problem that we need to encourage infrastructure investments.

Representative Dunn. Let me just ask you as follow-up, the President's budget has suggested a $300 million increase in the funds that will go to the LIHEAP (Low Income Home Energy Assistance Program) program, which, as you know, is the low-income energy program that could help folks in my district get through this tough time. Are there any other short-term solutions that you think are appropriate or that are put forward by – could be put forward either by the administration or by the Congress?

Dr. Hubbard. Well the LIHEAP program is a great example of trying to focus on the problem. That is, we are assisting low-income households, as opposed to a blunt approach of subsidies or price caps that are less sufficient. More generally, as the President suggested, if there were up-front stimulus as part of whatever tax package is passed by the Congress, that would also compensate for the, quote, tax that we have seen in higher energy prices. So that is another response.

Representative Dunn. And so the up-front stimulus would be what?

Dr. Hubbard. In other words, in the tax bill that is passed, there is an up-front stimulus in terms of money given quickly to taxpayers that would cushion higher energy prices this summer.

Representative Dunn. Okay, thank you. One last question, and I appreciate the Chairman's letting me do this, since I have how many seconds – 56 left.

I am interested in your opinion on an issue that deals with trade. We have not been successful in the last few years in negotiating bilateral original trade agreements. We have only finished two of them in the last eight years. That concerns me a lot. Other nations or regions like the European Union have completed 27 trade agreements in the same time period. The past decade has witnessed a flourishing free trade environment. The United States has undoubtedly played a major role in cultivating the new environment. In addition to shepherding regional agreements such as NAFTA, the United States has continued to serve as an uncompromising advocate for greater free trade among other nations. Unfortunately, trade agreements often bog down in Congress.

What is the negative effect on the United States' economy of the delay in implementing the bilateral and multilateral trade agreements, and what do you think, Dr. Hubbard, would be the economic benefit to providing the President with TPA, or trade promotion authority, as he has asked us to do the fast-track trade negotiating authority?

Dr. Hubbard. That is a wonderful question. While I can't give you a specific numerical answer off the top of my head, I would note that the big gainers, the big beneficiaries of what the President is asking for, are all of us as consumers. We are the winners from free trade. I think when the President referred to this as a moral imperative, he was thinking of this as a problem of raising consumers' living standards. And I think you can count on not simply the President's remarks, but Ambassador Zoellick's great efforts in trying to work quickly should we get the Congress' permission on Fast Track.

Representative Saxton. Dr. Hubbard, I would just like to pick up on something that Ms. Dunn was talking about. Every time I see the numbers on the chart to your right, they amaze me. That chart indicates – and I am wonder if you would care to comment – that the top 50 percent of the wage earners in this country pay 95.79 percent of the total tax revenues that are taken in, and that the bottom 50 percent of tax filers pay little better than 4 percent in personal income tax. That is amazing.

And as you work back to the left on the chart, the chart shows that the top 25 percent of the tax filers in personal income tax pay 82 percent, top 10 percent pay 65 percent, top 5 percent pay 53 percent, and the top 1 percent pay 34 percent. It is amazing. And that is one that always leads me to ask: How do you have tax cuts without having the top 50 percent have a bigger tax cut than the bottom 50 percent?

[The chart appears in the Submissions for the Record on page 54.]

Dr. Hubbard. Your chart makes the point, actually, much more articulately than I did when I was trying a few minutes ago. Simply the arithmetic of any tax cut that is going to focus on rates faces this pattern because the income tax burdens are so skewed. We have successfully taken many low-income Americans off the tax rolls, we have reduced income tax burdens for low-income Americans, and income growth has been very good for very high-income Americans. So I think your chart portrays quite nicely that any income tax cut will give very large dollar gains to high-income taxpayers.

Again, I would note for you that the President's tax cut is not an across-the-board cut. The distribution of the President's tax cut doesn't look like this. It would give more of the gains, net gains, to lower-income households.

Representative Saxton. Thank you. We have discussed in general terms three general pieces of Federal policy that are having an effect on the economy this morning, the first being tax policy. There are different opinions, but certainly we have discussed that at some length.

The second is energy policy. Would you discuss briefly what you think needs to be done in terms of energy and what the short- and long-term effects of a successful energy policy would be?

Dr. Hubbard. Well, I think the first premise of a successful energy policy is to focus on the marketplace and market incentives. We have seen improvements in energy intensity in the United States over the past two decades that are the result of market forces. Higher prices change behavior. So first and foremost to allow market forces to work is very important.

Second, where very long-lived investments required – related to the discussion about refining and electricity generation -- we must make sure we have minimal or as-low-as-possible regulatory uncertainty so that we get these investments built. If we create the expectation that we will change environmental regulations repeatedly over time or change a variety of review regulations repeatedly over time, it would come as no surprise that those investments would be curtailed. The short answer to your question is to let markets work and to stabilize the regulatory environment that utilities and the oil industry face.

Representative Saxton. Let me ask you about a third Federal policy that we don't have a lot to do with, but is hopefully going to have an effect on economic performance, and that is Fed policy. As we all know, the Fed has cut short-term rates by 250 basis points since early January. When do you expect to begin to see some result, or will we see a result? And if so, when, in your estimation, will we begin to see some economic impact as a result of Fed policy?

Dr. Hubbard. Well, first let me note that because of the Federal Reserve's independence, I don't want to comment too much on monetary policy. The Fed shares the same objectives of wanting high living standards that we all do. I think the Fed's policy actions over the past several months should be having very positive effects toward the end of the year, working through asset prices and working through the cost of funds for investments. One of the reasons I am optimistic about the end of the year, and about next year, is this combination of Fed policy, to which you just referred, and the tax cut that I trust you will be passing soon.

Representative Saxton. Thank you.

Mrs. Maloney.

Representative Maloney. First of all, could I request a copy of this chart so that I could see it? And this is personal income, right? And as you have said, you know the President's plan is focusing on reducing the marginal tax rates, yet the low-income families actually face the highest effective marginal tax rates because of the combination of income taxes, Federal payroll taxes, and the phaseout of benefits such as the EITC. And while the administration's plan does attempt to reduce some of these high rates, it would still leave many low-income families with significant barriers to work.

And is it the right way to measure the progressivity of the tax system to look at shares of a particular tax paid – in this case it is the income tax – or should we look at how the entire tax system is affecting the distribution of after-tax incomes and what has happened to the after tax-income share of those highest income households in the past decade?

Dr. Hubbard. You have raised a number of questions. First, regarding payroll taxes and the marginal tax rates faced by low-income households, the President's plan does significantly reduce the marginal tax rate for low-income families precisely because the child credit and the reduced lower bracket counteract some of the phaseout problem that you noted on the EITC. I think payroll taxes generally are a harder subject because, after all, payroll taxes are not a net tax. They are payments in contribution for a benefit. I think if one wanted to distribute the payroll tax, the minimum intellectually acceptable requirement would be to distribute the net tax that is involved, not the gross tax. So I think you would want to focus, at least for this purpose, more on income taxes. And if this is personal income taxes, you might also well want to add the distribution of other nonpersonal capital income taxes that are borne by individuals, like the corporation tax.

Representative Maloney. What does the administration's policy do for households that will be faced with higher gas and electricity prices this summer? Does the administration really believe what it says about the tax plan being part of the answer? The tax plan doesn't benefit those households who will be in the most need of greater cash flow for their purchases to pay their energy bills this summer.

Dr. Hubbard. As I had answered earlier, there will be an important cash component for all households to the extent that the Congress has a rebate as part of its proposals. That money could be used for anything a household finds most pressing, whether it is energy or a number of other needs. I think the President has wisely focused on long-term energy issues. The problems that are facing the country with energy aren't really specific to this summer. Perhaps less exciting, but very important, are long-term infrastructure issues. I think you will see improvements in energy prices and energy sufficiency in the future if we go that route.

Representative Maloney. Will they support the rebate that is in the Senate plan, the administration?

Dr. Hubbard. I think it is important for the Congress to work this out first. The President has called for an up-front piece in acceleration of his tax plan, and I am sure that the President would be willing to work with the Congress to make that happen.

Representative Maloney. And being a New Yorker, I am very concerned about the alternative minimum tax (AMT). And the Bush administration does not have much of a response to the AMT problem other than to claim it is a problem that was created by the Clinton administration. But that isn't quite honest. President Bush's tax plan would certainly worsen the AMT problem. And anyway, how can the Bush administration be so unwilling to handle the problems you claim you inherited from the Clinton administration, while being so willing to spend the surplus you inherited from the Clinton administration?

And we know that now in the AMT there are 20 million Americans in it, and with the Bush plan many economists estimate that it will grow to 35 million. So these people will not experience any type of tax cut.

Dr. Hubbard. You raise a very important point in the AMT. I don't want to get into finger-pointing about which administration is or isn't responsible, but I have to comment on the surplus. We don't inherit surpluses from Presidents. We inherit them from the energy and efforts of the American people.

On the AMT, you are absolutely right. It is a big problem. What the President said was, let's focus first on the problems we think have the highest deadweight loss – to use the Chairman's terms – and he believed that those were marginal rates.

The President has said, and the Secretary of the Treasury has said, that this is not likely to be the last tax proposal that you are going to see from the administration. There is keen interest in the administration in AMT reform.

Representative Maloney. Well then, it should be part of this proposal, because for the 20 million families that are in it now, growing to 35 million, many of them in states like New York that have a state and city tax, these are middle-class families that are going to be pushed into the AMT, and they will possibly have more taxes to pay in certain categories. And to say, don't worry, that is going to be in the future; it should have been part of this plan, wouldn't you think?

Dr. Hubbard. I don't think so, but as a west-sider in New York, I share the same concerns as you have on the east side.

Representative Maloney. I bet it affects you, right, the AMT?

Dr. Hubbard. No, it doesn't affect me, but it might soon, having moved here. Again, it is not so much that we are ignoring the problem, but that in the list of priorities, the President selected the marginal tax rate reductions first. I don't think you should take that as a statement of lack of interest in the AMT.

Representative Maloney. Well, I hope you are right. It certainly doesn't help the 20 million that are suffering from it now, many of whom are middle class, and many of whom are in States like New York.

On bracket creep, the two top brackets have only a small percentage of taxpayers, but that is where a great deal of the income growth occurred. And isn't it strong income growth among people in the top brackets that accounts for a significant share of the growth in revenue, not bracket creep; and isn't this just the progressive tax system working as it should?

Dr. Hubbard. There are really two factors that come up. One is for people who are in every period in the same rate bracket, and their gross income. As you pointed out correctly, in pre-tax income, growth at the top of the income distribution has been high relative to the general public. But there is also a great deal of mobility in our society. Moving up, comes both from taking risks and from improving one's wage profile over time. I think the estimates indicate that real bracket creep is still a fairly substantial portion of the problem. As real incomes grow, people move into these higher tax brackets. You are quite correct that income growth at the top has also been high.

Representative Maloney. Getting back to energy. Is there a trade off between environmental quality and economic growth? Should conservation be reserved as a, quote, private virtue and not pursued as a public goal? And what did the Vice President mean by this? And isn't conservation a truly important public good that justifies a role of government in conservation?

Dr. Hubbard. Of course, I don't want to try to interpret the Vice President's statements. You would have to ask him that. But I think that we have seen a lot of conservation in the U.S. from very straightforward market incentives. It has happened naturally.

Your larger question, which is extremely important, is on whether there is a tension between the energy goals on the one hand and environmental goals on the other. I will give you two answers on that. One, as a general matter, I don't think there needs to be, particularly with the technology changes we are experiencing. I think the encouragement of alternative technologies, part of which is in the President's energy plan, lessens that tension.

But having said that, I think we as a society have to keep in mind that when we have certain environmental regulations, we may affect capacity decisions. We have to decide as we think about how many power plants we need and what kind of energy infrastructure we need, what is the marginal value of those regulations. That, indeed, is a tension.

Representative Maloney. Well, earlier when we were talking about the alternative minimum tax, you were saying don't worry, we are going to take care of that in the future. But what really bothers me is there are a lot of things that the administration is saying is a, quote, priority that we are going to take care of in the future, such as defense, the IDEA spending. And you know, where is that in the budget; and doesn't not taking care of it now in effect threaten Social Security and Medicare and the reserves we are building up there, because we haven't taken care of defense, IDEA or the alternative minimum tax in this current tax plan.

Dr. Hubbard. I don't think so. After all, you identified a number – we could identify even more – of high-priority issues for the country. The question is the timing, getting things developed in the administration, and getting through the Congress. The budget information from both the CBO and the Office of Management and Budget indicates that there is room for the priorities that the President has articulated. The solutions on Social Security are dependent upon what the Social Security Commission recommends to the President, and then what he decides to present to Congress.

Representative Maloney. I would like to go back to your statements on the distributional analysis of the tax policies. And really following the pressure of many people this Congress and others, the administration did come out with its own form of annual distributional analysis, and why did the numbers focus on changing shares of income taxes paid or on percentage changes in income taxes rather than a more meaningful examination of what happens to the distribution of after-tax incomes?

Dr. Hubbard. I think the reason is that most common-sense discussions of progressivity focus on those percentage measures that are easiest. I think that the Treasury reported a wide variety of measures just to give as much information to you as possible.

Representative Maloney. And why did they leave out the effects of repealing the estate tax in that assumption, even though Treasury distributes the estate tax as part of its standard methodology?

Dr. Hubbard. There are two parts to your question; I will take the last part first. There is no longstanding tradition in Treasury of distributing the estate tax. It has been done in recent years. In the past it hasn't. But the more substantive answer to your question is that distributing the estate tax is not a straightforward exercise. Further, the internal calculations in Treasury that have distributed the estate tax still have a distribution table that is quite progressive for the entire plan.

Representative Maloney. My time is up. I thank the Chairman.

Representative Saxton. Thank you. Dr. Hubbard, let me try to summarize where I think we are in this tax debate. You have indicated that various things that occur sometimes as a result of Federal policy, sometimes as a result of other things that happen, affect people's behavior. Today's energy costs this summer will affect people's behavior in some way, not that I know exactly how, but there is bound to be an effect. We are hoping that Fed policy, current Fed policy, has an effect on people's behavior and that that will cause positive effects in the economy.

Republicans and Democrats have both argued these points and at certain points agreed on this very basic premise that economic stimulus affects people's behavior and that sometimes, therefore, we have positive or negative effects on the economy.

The first person that I remember on the Democrat side arguing this point successfully was John Kennedy in 1963 in his State of the Union address. Forgive me if I don't have these words exactly, but something like, "We can't expect to be a world leader if we fail to set the economic pace at home." And he went on in the rest of his State of the Union address, talking about how he thought we should reduce the tax burden on people to have an effect on their behavior and hopeful positive effect on economic growth.

And then in the early '80s, someone who the Republicans championed, Ronald Reagan, made a similar speech. And it wasn't until after he made his speech that we realized that we Republicans didn't invent the notion that Federal policy can have an effect on people's behavior, and in turn that can have an effect on the state of the economy, but we were very proud of the notion that Ronald Reagan espoused that we needed to cut taxes in order to relieve the burden on people and to produce the positive results that we saw subsequent to that.

We saw economic growth after the Kennedy tax cuts. We saw economic growth after the Reagan tax cuts. As a matter of fact, I would go so far as to argue that much of what we have seen in the last 17 years has been partially, maybe largely, but partially a result of the tax policies that were put in place in the early '80s.

So much has been said about this. And further in your statement, you argued that the proposed tax cuts are significantly smaller than either the Kennedy or the Reagan tax cuts.

Would you talk about this tax proposal in the historic perspective in terms of this notion that, simply put, we are hoping and believe that we will affect people's behavior and cause long-term economic growth?

Dr. Hubbard. Yes. I think you made two excellent points. One is the point that partisanship should have nothing to do with interest in marginal tax rates. A Democratic administration and a Republican administration, in your examples, had very large marginal tax rate cuts, indeed larger in terms of their steady-state cost than those we are talking about today. I think the interest should be in improving living standards for all Americans.

Again, I think the evidence is abundant. Cuts in marginal tax rates both improve the real growth prospects for us all, but also root out much of the waste in the tax system that you correctly identified. The other point is that the proposal of the President, and the proposal you are debating in the Congress, is smaller than these examples. This isn't a radical departure in fiscal policy. It is really more trying to stabilize the individual income tax share of GDP.

Representative Saxton. Dr. Hubbard, thank you. I have no further questions at this point. We would again like to thank you for taking time to come and visit with us and share your thoughts this morning. We will continue our task here at looking at Federal policy, and from time to time we hope we will be able to call on you for your thoughts and input on these subjects. Thank you very much for being with us.

Dr. Hubbard. Thank you, Mr. Chairman.

Representative Saxton. The hearing is adjourned.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Chairman Hubbard, it is a pleasure to welcome you before the Joint Economic Committee this morning. I believe this is your first appearance before Congress as Chairman of the President's Council of Economic Advisers, and we look forward to your testimony.

The long period of economic growth that began in the 1980s has continued, aside from a short and mild recession in the 1990-1991 period. The economic benefits of such a sustained period of economic growth are reflected in the general prosperity and health of the economy evident through the middle of last year. Real GDP growth has been strong as labor productivity gains led to higher output and income. Inflation has been reduced by the Federal Reserve, interest rates have trended downward, and rates of unemployment and poverty have fallen over the course of the expansion.

However, as I noted last December, the economy has entered into a sharp slowdown that began around the middle of last year. Real GDP growth fell from 5.6 percent in the second quarter of 2000 to only 1 percent by the end of the year. Investment, consumption, and employment have also reflected the sharp slowdown. Manufacturing employment has been declining since July of last year, and employment losses are now spreading to other sectors of the economy.

The Federal Reserve has responded by sharply reducing short-term interest rates and relaxing monetary policy over the last five months. I believe the actions of the Fed will significantly improve the prospects for a resumption of healthy economic growth later this year. However, I remain concerned about current economic conditions as reflected in the recent two consecutive declines in payroll employment. Although I do not believe the tax bill currently under consideration will make the economy turn on a dime, I do think it will have a positive effect over the next year that is much needed in the current environment.

The weak economy is bearing the burden of a tax system that is systematically biased against work, saving and investment, and is literally counterproductive. Real bracket creep gradually continues to push taxpayers into higher tax brackets. The additional burdens of what economists call deadweight losses are a significant problem that is not well recognized by many policymakers.

Essentially, deadweight losses arise because the tax system imposes added economic costs in addition to the revenues raised by taxation. In other words, for every incremental dollar raised in revenue, the tax system imposes others costs amounting to 30 or 40 cents on the economy. Thus, each dollar in tax reduction can provide significantly more than a dollar in benefits to the economy. In my view this is a key reason to reduce the burden of our counterproductive tax system.

Fortunately, progress is being made on a bipartisan tax bill to reduce the tax burden on the U.S. economy. It will not solve all our immediate problems, but it will improve the prospects for healthier economic growth in the years to come The stronger economy will, in turn, help us to address the longer-term economic and budget challenges facing the nation. We have a tremendous opportunity to enhance the economic future of America by reducing the weight of our counterproductive tax system.

Statement of Rep. Carolyn B. Maloney
Joint Economic Committee Hearing on the Economic Outlook
May 23, 2001

Thank you Mr. Chairman for holding this hearing today on the state of the economy. As we have seen since the middle of last year, economic growth has slowed dramatically.

The manufacturing sector has lost over half a million jobs. Only continuing strength in the services industry and strong household spending have kept a recession from spreading throughout the economy.

Unfortunately, recent signs are cause for increased concern. The recent sharp rise in the unemployment rate and the potential impact of high energy prices on household budgets could lead to increased economic difficulty.

The current Administration's one-note answer to all these problems has been its tax cut proposal. While I am personally certain that Congress could pass historically large, responsible tax cuts on a bipartisan basis, the bill that we will vote on later this week is no such agreement. The President's plan risks a return to deficits and is fundamentally unfair to lower income workers and to my state of New York.

As introduced, the Bush tax bill was so large and based on economic assumptions that can vary so greatly that we risk deficits if our numbers are only slightly off. The Senate bill is only marginally better.

CBO, whose rosy projections are the basis for the tax cuts, indicated that its average error margin in projecting budget surpluses or deficits for a fiscal year in progress has historically been about 0.5 percent of the Gross Domestic Product (GDP). In the current economy this would be $54 billion in one year.

As for projecting five years out, CBO's average error has been 3.1 percent of GDP, a six-fold increase. Many of the Bush tax cuts do not fully phase-in for 10 years in order to hide their tremendous cost. To borrow a Bush catch phrase, using CBO projections bassed on continued strong economic growth for the next 10 years is truly "faith-based" budgeting.

While the tax cut itself is large, it is not so large that it provides relief to the lower income Americans who pay the majority of their taxes through payroll taxes rather than income taxes.

Ironically, it is these Americans whose household budgets are most affected by rising energy prices. While President Bush has suggested that the tax cut be enacted to pay for sky-rocketing energy costs, his plan does not benefit these very workers.

Finally, the tax bill on its face is fundamentally misleading. Provisions granting marriage penalty relief and estate tax repeal are so costly that they do not fully phase-in for a decade. Well after President Bush has returned to Texas, the full force of these provisions will confront the country just as the baby boom generation increases its reliance on Social Security and prescription drugs.

Most misleading about this tax bill is that it treats taxpayers with similar incomes far differently based on the state in which they reside. This is because it greatly increases the impact of the Alternative Minimum Tax which eliminates deductions for state taxes.

The non-partisan Joint Committee on Taxation estimates that our current tax code will push 20 million taxpayers into the AMT over the next 10 years. The Bush plan increases this number to 35 million. This impact is not news to the Bush Administration. The President knew when he introduced his plan that the $1.6 trillion in tax cuts was not "just right" and that an AMT fix is necessary. Signs from the Administration and Congressional leadership are that any such fix will only be included in the next tax bill. I do not believe this is a responsible way to pass a tax cut or a budget that has yet to take into account the defense review.

The Administration has argued that its tax bill will boost the struggling economy, and, at the same time, that the economy is strong enough that a large tax cut is not fiscally irresponsible. I am afraid they have missed both targets.

Opening Statement
of
Senator Jack Reed, Ranking Member
Joint Economic Committee Hearing on the Economic Outlook
May 23, 2001

Thank you, Mr. Chairman. I want to commend you for holding this hearing. This is a critical time to be examining questions about how the economy is performing and whether we are pursuing the best policies for achieving the kind of sustainable growth that brings prosperity to all of our citizens. It is fitting that our witness is the Chairman of the Council of Economic Advisers, our sister agency, created along with the Joint Economic Committee by the Employment Act of 1946.

Mr. Chairman, over the last 10 years, the United States has experienced its longest economic expansion on record. It has been an expansion in which the unemployment rate has fallen to levels that were last seen 30 years ago, one in which inflation has remained tame, and one in which investment and productivity growth have been particularly strong. One especially noteworthy aspect of this expansion is how well traditionally disadvantaged groups have fared. They have seen job opportunities open up and they have seen their incomes grow, after a couple of decades of stagnation. However, the expansion has hit some speed bumps recently and we want to be sure that we are pursuing policies that keep the economy on track.

I think it is worth reflecting on the policies that helped generate this strong expansion. The policy approach of the 1990s rested on three major pillars: fiscal discipline, investing in people and technology, and opening markets at home and abroad. One of the most important of these pillars was the fiscal discipline that turned massive budget deficits into surpluses and that has created a budget outlook in which we have the opportunity, if we act wisely, to address critical long-term budget challenges such as paying down the national debt and preparing for pressures that will be put on medicare and social security by the retirement of the baby boom.

I look forward to hearing Dr. Hubbard's views on the economic outlook and his analysis of the policies that he believes will best keep the economy on track in the short run and promote prosperity in the long run. But I also hope we can engage in a constructive dialogue about whether the policies being promoted by the Administration are in fact the best policies for achieving those goals. I am particularly concerned about whether this Administration remains committed to sound fiscal policies and the importance of investment in people.

Mr. Chairman, a President's first budget is an important statement of his Administration's priorities, and it seems pretty clear that President Bush is intent on passing a large tax cut. Many of us think that the tax cut is too large, given the uncertainty that exists in the forecasts of the baseline budget surpluses. It leaves too little room for other important national priorities such as education, national defense, and prescription drugs, unless the actual budget surpluses turn out to be much greater than expected. Such an outcome is possible, of course, given the wide range of uncertainty in the CBO budget forecast; but unless the economy recovers quickly and strongly, it seems more likely that the surpluses will be smaller than currently projected rather than larger.

Based on an analysis of its own forecasting record, the CBO says there is a $600 billion margin of error in its baseline surplus estimate just five years out. CBO's forecast assumes a brief slowing in the economy this year, but recent economic data on employment and industrial production suggest that we may experience even slower growth in the short run than CBO assumes. If the tax cut actually provided the stimulus that the budget resolution calls for, we might have some reason to be confident that the economy could get back on track quickly. But stimulus got left out of this tax cut, so the risk would seem to be on the side of slower growth and smaller surpluses in the short run.

In the long run, the size of the surplus depends on how fast the economy grows, and that depends on productivity growth. The most recent data suggest that productivity declined in the first quarter of this year. This probably just reflects the short-term business cycle, in which case it will be short-lived. But if we are, in fact, seeing a decline in long-run trend productivity, the surpluses will be smaller than projected. CBO's estimates suggest that 1 percent per year slower growth in productivity would reduce the 10-year surplus by $2.4 trillion.

So I am interested in Dr. Hubbard's view of how the tax cut will affect the economic and budget outlook, not just over the next 10 years, but over the years immediately following when the baby boom starts to retire. I am worried that we are throwing away the fiscal discipline that was one of the key policy pillars on which the long economic expansion of the past decade was built in order to enact a large tax cut with great haste and little consideration.

Earlier, I mentioned how the recent expansion has helped traditionally disadvantaged groups to do better economically. In addition to pursuing fiscal policies that promoted strong private investment, the previous Administration focused on making work pay by raising the minimum wage and expanding the Earned Income Tax Credit. This Administration's priorities seem to lie in another direction. The key elements of the President's tax plan seem to be lowering the marginal tax rates paid by the small minority of taxpayers at the very top of the income distribution and repealing an estate tax that few Americans face a realistic probability of paying. I hope Dr. Hubbard can help us understand how the Administration's economic plan will affect ordinary Americans.

Finally, I hope we talk about all the ways that government can promote economic prosperity for all Americans, not just by providing incentives through the tax system but also by promoting national saving through fiscal discipline and by encouraging prudent investments in infrastructure and people. One of our roles at the Joint Economic Committee should be to encourage policy discussions about the trade-offs involved in our different policy choices. For example, the decision to cut taxes substantially is at the same time a decision to reduce government saving. Are the incentive effects from the tax cut large enough to offset the loss of national saving? What would be the effect of spending more on education that improved the skills and flexibility of our future workers and less on a tax cut? These are the kinds of questions we should be asking.

I thank the Chairman, and I look forward to Dr. Hubbard's testimony and to opening up a dialogue with him on these important issues.

Statement of Senator Jon Corzine
Joint Economic Committee Hearing
Hearing on America's Future Economic Outlook
May 23, 2001

Thank you Mr. Chairman. It's a pleasure to be at this, my first, hearing as a member of the Joint Economic Committee. And its focus – on our nation's future economic outlook – is obviously an important one.

I look forward to the testimony of the Chairman of the President's Council of Economic Advisors. Having heard Mr. Hubbard earlier this year during his confirmation before the Senate Banking Committee, it'll be interesting to see what, if any, new insights he has to share regarding the state of our economy.

As we are all well aware, our nation's economy has been mired in a slowdown, and been on the verge of a recession. Retail numbers have flattened out, business investment has decreased and productivity has declined. Job growth has leveled off, layoffs are on the rise and initial claims for unemployment insurance have reached their highest levels in eight years. Additionally, consumption has waned and Americans are increasing their debt burden at an alarming rate.

The Federal Reserve, and Chairman Greenspan, have taken an aggressive approach to stemming this negative economic tide, most recently by lowering interest rates by half a percentage point. Over the first five months of this year the Fed has cut short-term interest rates by 250-basis points.

But despite the best efforts of the Fed, threats abound. Energy prices along with rising long-term interest rates may discourage further investment, decrease productivity and feed greater pessimism about inflation.

Households, investors and businesses have all registered their concerns regarding our future economic outlook in the consumer confidence indices and in our markets. They have witnessed a Congress that cannot – or will not – exercise the type of fiscal discipline that our current economic situation requires. They're concerned about the increased prospects of deficit spending and decreased prospects for continuing economic growth.

As we have debated the reconciliation tax bill in the Senate these past several days, I find myself growing less optimistic that this Congress and this administration will exert the type of fiscal leadership that our nation needs during this period of enormous economic uncertainty.

We appear destined to repeat mistakes that we made in 1981, when Congress approved a tax cut plan that was eerily similar to this one. Many of us here remember that that tax cut drew our economy into a deep recession that our nation needed an entire decade to recover from.

Frankly, America deserves better than to be led, blindfolded, down the road to economic ruin.

I look forward to a lively discussion today and thank you again Mr. Chairman for holding this hearing.

Thank you.

Statement of
R. Glenn Hubbard
Chairman
Council of Economic Advisers

before the

Joint Economic Committee

Wednesday, May 23, 2001

Mr. Chairman, Senator Bennett, Senator Reed and Members of the Committee:

I am delighted to have the opportunity to appear before you in my capacity as Chairman of the Council of Economic Advisers. The Council and I look forward to working with the Committee in its analysis of the economy and economic policy. Today, I welcome the opportunity to comment upon the outlook for the U. S. economy, and to present our view upon the policy challenges facing the Nation.

BACKDROP

The Long Boom

The current expansion is the most recent manifestation of accelerated long-term growth that began in the 1980s with the advent of a number of changes in the private economy and policy direction. These new policies include the pursuit of price stability through a steady monetary policy, an extensive process of deregulation in many sectors of the economy, and reductions in the tax burden facing American households and firms.

From 1982 onward, real GDP has grown at an average rate of 3.5 percent per year, as compared with 3.0 percent during the previous decade. Similarly, productivity in the nonfarm business sector has grown at an annual rate of 2.0 percent since 1982, as compared with 1.4 percent in the earlier period. From 1995, the acceleration in trend productivity was even more pronounced, with growth averaging 2.6 percent per year. These accomplishments have coincided with a period of low inflation. Inflation rates have declined from an average 8.8 percent during the 1972-81 period, to an average 3.3 percent from 1982 onward. Moreover, the volatility of inflation has also declined from 3.5 percent to 1.6 percent. These macroeconomic achievements are built upon a foundation of microeconomic initiatives such as: the deregulation of the airline and trucking industries, as well as the oil and natural gas producing sectors. Also very important, reductions in marginal tax rates (with the notable exception of the early 1990s increases) have set the stage for increased labor force participation, as well as the entrepreneurial achievements that have made American prosperity and technological prowess objects of emulation

Recent Developments

Since late 2000, the economy's rate of growth has slowed substantially. Beginning in the fourth quarter of 2000, growth declined from the unsustainable rate of 4.2 percent recorded in the first three quarters. Real GDP growth slowed to 1 percent in the fourth quarter, and 2 percent in the first quarter of 2001. The Conference Board's index of coincident indicators peaked last September at 116.6, dipped to 116.3 in January, and at 116.5 in April, remains below the September peak.

Despite the recent deceleration in economic growth, it is unlikely that the U.S. economy is in a recession, as real growth has been and is anticipated to remain positive. The May Blue Chip consensus of economic forecasters foresees real GDP to grow 2.2 percent during the four quarters of 2001, and 3.4 percent during 2002. Nevertheless, there are some negative factors that threaten to delay a full recovery in growth.

Pressures on the Economy

Consumption. Consumption, which accounts for approximately two-thirds of aggregate demand, has held up relatively well during the recent growth slowdown. The resilience of consumption is especially remarkable given the reduction in wealth that has accompanied the decline in equity prices, as consumption (relative to income) tends to track wealth over the medium term. Estimates of the change in consumption for a dollar's change in wealth range from three to five cents, with the lag extending up to about two years after the shock. To the extent that these relationships hold, one should expect a period of slow consumption growth.

In line with the downturn in some asset prices and economic growth, indicators of consumer confidence have also posted warning signs. The University of Michigan index of consumer sentiment has been trending downward since November, but has recently retraced a fraction of that loss. The preliminary reading for May is 92.6, up from a final measure of 88.4 in April. Despite the decline over the past six months, the index remains above its historical average.

A key question in assessing consumption prospects is whether the rate of unemployment will continue to rise, and whether the associated income uncertainty will depress consumer spending. The payroll unemployment rate rose from 4.0 percent in December to 4.5 percent in April. Private payroll employment fell in March and April, with losses continuing in manufacturing and help-supply services. The recent level of initial claims for unemployment insurance suggests that the unemployment rate will likely continue to rise over the next several months, although last week's figures on unemployment insurance claims were somewhat more positive.

Investment. Business fixed investment spending overall has stagnated over the past two quarters. Equipment and software growth declined noticeably in the fourth and the first quarter and orders suggest a further decline in the second. In contrast, investment in non-residential construction is up sharply, with first-quarter real investment 10 percentage points above its level a year ago. This growth is being led by construction in energy extraction industries, and is likely to continue as more electricity generating plants are built.

Investment in information technology (IT) equipment has also decreased. Earlier increases in equity values in this sector may have encouraged a bit too much investment. The legacy of this possible over-investment may take a few quarters to re-equilibrate. Given the rapid technology gains and rapid depreciation, we expect IT investment to rebound by year-end.

There are basically two ways to calculate how adjustment to the equilibrium capital stock -- determined by output and the user cost of capital -- will be achieved. The first is to estimate a model wherein investment expenditures adjust in a manner to gradually work off the excess amount of capital. The second approach relies upon a cash flow model to determine the investment rate -- the greater the retained earnings, the greater the amount of investment.

Estimating the overhang is a challenging task because our knowledge of the economic rate of depreciation of IT equipment and software is limited. Assuming smooth adjustment to the desired capital stock, the overhang might be eliminated quite quickly. However, if investment is highly dependent upon corporate cash flow, the adjustment might be sharper.

Energy Prices. The rising cost of energy over the past two years has exerted a kind of tax on both consumers and those firms that are not energy producers. Although the share of the households' budgets devoted to energy needs are not at historical highs, the elevation of relative prices comes at a time when the economy is fragile. Similarly, firms face increased energy costs in a period of slackening demand.

<u>Petroleum</u>. From late 1998 through 2000, the prices of many energy products rose sharply from their low levels. Imported crude oil rose from as little as $10 per barrel to over $30 per barrels; as recently as 1997, it had cost $20 per barrel.

In order to assess the economic consequences of higher oil prices, it is important to make the distinction between permanent and temporary energy price increases. To the extent it is unlikely that the oil prices in 1998 were long-term equilibrium prices, it may be more reasonable to use the $20 price as a baseline. Evaluated from this perspective, the relevant price increase (that might be expected to persist for some years) was about $10 a barrel or approximately 50 percent (the price of West Texas Intermediate currently is approximately $28 per barrel).

A recent International Monetary Fund analysis* of oil price shocks on the U.S. economy determined that a price shock of this magnitude results in a 0.2 percentage point reduction in output below what it otherwise would have been in the first year after the shock, and a 0.4 percentage point reduction in the second year, with the effect diminishing thereafter. The shock adds 0.2, 0.7 and 0.5 percentage points, respectively, to core inflation in the years after the shock. Another macroeconometric model suggests that an increase of $10 per barrel yields a 0.4 percent reduction in output relative to baseline in the first year. While the models differ in their exact predictions, they yield similar magnitudes of effects. Given relative stability in oil prices through the latter part of 2000 and indications from futures markets of a slight decline in prices, barring future negative shocks, we anticipate the effects of the oil price increase should dissipate over the next year.

Natural Gas. In assessing the impact of higher natural gas prices, it is important to recall virtually all of the 16 percent of natural gas consumption that is accounted for by imports originates in Canada, a large importer of U.S. goods. Thus the net "withdrawal" of spending from the U.S. economy is relatively small because a large proportion of the resulting Canadian spending returns as U.S. exports.

Compared with oil, the reduction of GDP due to natural gas spending leaking abroad is roughly one-sixth to one-seventh the impact experienced from higher oil prices.** Overall, the largest economic effects are domestic and redistributive in nature – from natural gas consumers to natural gas producers.

Natural gas prices are higher relative to trend all over the country. However, they are highest in California. Even there, a recent study published by the Federal Reserve Bank of San Francisco notes that "...although rising natural gas prices have hurt some producers and consumers in the Twelfth [Federal Reserve] District, there is little evidence that rising costs have significantly slowed economic growth in the region." Further, the study observes that expenditures on natural gas in the Twelfth District amount to less than one percent of gross state product.***

It is also of interest that some firms have stopped production, not because they cannot afford to purchase natural gas, but because they have forward contracts for natural gas, and find it more profitable to resell the gas than to use it to produce their goods.

The differential prices for natural gas observed across the regions, and occasional interruptions in gas supply, buttress the Administration's argument that more resources need to be devoted to enhancing the Nation's natural gas delivery infrastructure. Accordingly, the National Energy Development Policy task force has highlighted this policy measure in its report.

*Benjamin Hunt, Peter Isard and Douglas Laxton, "The Macroeconomic Effects of Higher Oil Prices," *IMF Working Paper* WP/01/04, 2001.
**This calculation compares the change in import value due to higher prices, relative to GDP
***Mary Daly, "Economic Impact of Rising Natural Gas Prices,"*Federal Reserve Bank of San Francisco Economic Letter* 2001-04 (February 9, 2001)

California and the Electricity Situation. Most analysts have concluded that the reductions in electricity consumption (due to rolling blackouts and voluntary outages) have thus far had only a small impact on gross California state product and hence national GDP. The likely impact of the outages during the upcoming summer months is much more difficult to determine given the vagaries of the weather and the uncertain quantitative impact on demand of the new rate structure implemented by the California Public Utilities Commission on May 15. The damage from summer blackouts is likely to be limited because firms with critical needs for uninterrupted power have installed backup generators. Assuming some reduction in demand due to higher retail prices, and a moderate summer, third-quarter GDP growth might not be reduced noticeably, while an unseasonably hot summer, combined with no additional action on the pricing front, would result in a clearly noticeable impact.

The major impact on California will be felt in the longer term, as firms make decisions regarding where to locate. Firms that rely upon a stable, uninterrupted supply of electricity, or use energy as a key component of their production process, are most likely to opt for locating outside of California, and perhaps even outside of the United States.

The Foreign Sector: Effects on the Rest of the World. Changes in economic conditions have not been restricted to the United States. The global economy has also experienced substantial reductions in growth and employment. These changes are not completely unrelated; rather they represent a complex set of interactions between the U.S. economy and its economic partners.

As the largest single economy and financial market in the world, trends in the United States have a substantial impact upon the rest of the world. Rapid growth in the United States during 1999 and 2000 sustained, through demand for their exports, the economic buoyancy of East Asia and (to a lesser extent) Europe. The slowdown in the U.S. economy, particularly in electronics and semiconductor products, has resulted in a substantial decline in growth prospects in those East Asian economies that specialized in these export markets.

The Euro area in particular is perhaps more susceptible to U.S. economic influences than many European policymakers have perceived. Most of the focus had been on the fact that trade flows between the United States and the Euro area are not particularly large. However, in this era of highly integrated product and financial markets, developments in asset markets can have ramifications far outside national borders.

The Foreign Sector: Rest-of-World Effects on the United States. While events outside of the United States can have an effect upon the U.S. economy, quantifying those effects is not straightforward. In general, it is our view that, aside from a systemic financial crisis, it is unlikely that events outside the United States will have a large impact upon domestic economic prospects, largely because trade accounts for a small share of the U.S. economy. As a proportion of GDP, exports are about 11 percent. Moreover, the United

States is not overly sensitive to developments in regions vulnerable to recession; for example, U.S. goods exports to the Japan only comprise 8.3 percent of total U.S. exports.

Furthermore, foreign financial markets are small compared to those in the United States. Even to the extent that the United States relies upon foreign savings, there does not appear to be cause for current alarm from recent trends. As U.S. economic growth has slowed, and equity markets experienced a correction, the willingness of foreign investors to purchase U.S. assets has not abated. Inflows of capital to purchase U.S. equities continued into the fourth quarter of 2000 (the last period for which data are available), despite declines in the major indices. As a further indication of this phenomenon, the value of the dollar has continued its upward trend in the first quarter, even as U.S. equity indices continued their decline and euro area growth rates exceeded that of the United States.

The current account deficit, which includes net payments such as interest, dividends and remittances, was $435.4 billion in 2000, or 4.4 percent of GDP. This current account balance reflects the desire of global investors to invest in the U.S. economy.

Long-term Outlook

Over the longer term, the prospects for the U.S. economy remain bright. I say this because of the acceleration of trend productivity growth observed over the last few years, and the accompanying rise in the growth rate of potential output, making possible rising living standards and low inflation. Over the 1973 to 1994 period, the average annual growth rate of labor productivity in the nonfarm business sector was 1.3 percent. Since 1995, it has been 2.6 percent. Over the same period, manufacturing productivity has grown at 4.7 percent annum , versus the 2.5 percent per annum rate observed in the earlier period.

The latest release on productivity growth has given some observers pause for thought. Two cautionary points are in order. First, labor productivity is procyclical, so that some reduction in productivity growth is to be expected. Second, the surprisingly low productivity growth rate for the first quarter is likely to be downwardly biased because of the difficulty in measuring self-employed hours. Subsequent observations on productivity are likely to reaffirm a higher trend growth rate.

Rapid productivity growth, upon which our future prosperity rests, does not occur in a vacuum. It depends upon the appropriate policy framework. This framework should consist of policies that minimize interference with the accumulation of factors that contribute to growth.

IMPACTS OF THE PRESIDENT'S PROPOSALS

The President's tax plan is one example of such policies. Let me begin by reviewing the context in which the President's tax proposals were developed. The

President's plan was developed in the midst of a sustained period of rapid economic growth that had increased the overall tax burden (Federal tax revenues as a share of GDP) to over 20 percent – a post-war high. Over the course of that expansion the underlying fiscal position of the Federal government improved. Having taken steps to improve the sustainability of the Social Security system and reduce significantly the outstanding debt held by the public, the President's budget proposes to reduce the overall tax burden efficiently and fairly.

Now, since the inception of the President's proposals, immediate attention has swung from a rapidly growing economy to the need to ensure the continuation of steady growth. The tax cut was not initially designed to be a "stimulus package." The goal was to return a significant portion of the on-budget surplus to taxpayers in an economically efficient fashion. Fortunately, it can serve as both. Permanent cuts in marginal tax rates will have immediate and significant economic effects. Indeed, the evidence is that a purely temporary "stimulus" tax change would have much more modest impacts than the President's plan.

Still, the plan is primarily targeted toward long run objectives. Viewed from this perspective, an unfortunate feature of most of the debate has been its focus on "size." Some critics have argued that the economy somehow cannot afford to return $1.6 trillion dollars to the citizens who earned it.

This concern is somewhat surprising. The President's budget outlines clearly how the tax cut co-exists with preserving Social Security and Medicare, and prudent increases in other necessary government programs. Moreover, when viewed in the context of the large U.S. economy, the cuts are quite modest. Over the budget window, the tax plan amounts to only 1.2 cents in each dollar of GDP. In comparison, the President's proposed tax cuts are less than one-half the size of the Kennedy tax cut, roughly one-fourth the size of tax cuts proposed by President Reagan, and takes place in an overall context of budgetary discipline.

Or, taking another perspective, the President's tax cut compensates for "real bracket creep." The idea of bracket creep is familiar. Taxpayers once were forced into higher tax brackets due to purely inflationary increase in their nominal incomes. Indexing tax brackets for inflation solved this kind of bracket creep. However, the tax system is not immune to *real* bracket creep. As the economy grows, the real incomes of households rise; pushing them into higher tax brackets. In the absence of a significant tax cut, real bracket creep will result in an increasing share of income being paid on taxes. The President's tax cut will simply reduce the share of individual income paid on taxes to levels that were in existence in the prior ten years.

A second unfortunate aspect of the public discussion has been some of the misleading assertions regarding the fairness of the tax cut. The President believes that everyone who pays income taxes should receive an income tax cut. However, consistent with his concerns for our least-well-off citizens, the largest percentage tax cuts are reserved for lower-income families.

The percentage reduction in income tax burdens under the President's proposal is the largest – a reduction of 136 percent – for the lowest income group (under $30,000). The percentage reduction is smaller but above average for families with incomes between $30,000 and $100,000. The percentage reductions are below average – –9.5 percent – for families with incomes over $100,000.

In addition, under the President's plan, the share of income taxes paid by upper-income households will rise. Families with incomes under $100,000 will pay a smaller share of the total income tax burden under the President's proposal than they do under current law: 25.8 percent versus 30 percent. Conversely, families with incomes of $100,000 or more will pay a larger share of the total income tax burden under the President's proposal than they do under current law: 74.2 percent versus 70 percent. By standard measures, the proposed tax cut is progressive.

However, from my perspective, the most dissatisfying aspect of much of the discussion has been that it fails to address the economic impacts of the President's proposals.

To begin, the key to the President's plan is its focus on reducing marginal tax rates. We are now quite familiar with the notion that accumulating physical capital, human capital – education, skills, and training – and new technologies is the heart of sustained economic growth and prosperity. There is now a large body of evidence that improving marginal incentives – the additional reward to effort, investment, innovation, and other activities – is the key to ensuring these investments in our economic future.

Almost all taxes interfere with the smooth functioning of a market economy, leading to reduced labor supply, investment, and GDP – economists have labeled these losses the "deadweight loss." High marginal tax rates are especially damaging, so the gains to reducing high marginal rates are quite striking. Cutting marginal rates in half, for example, yields reductions in deadweight loss by more than a factor of two. By reducing marginal tax rates, the President's plan will enhance economic performance.

The visible benefits of lower marginal tax rates will be seen across the spectrum of economic activity. Economic research has established strongly the link between taxes and the decision to start or continue working: reductions in taxes bring low-wage and low-income individuals into the labor force, lower marginal tax rates – both explicit and implicit in our social insurance programs – permit the continued work effort of our most experienced and skilled workers: America's older workers. Lower marginal tax rates also have been shown to induce second-earners in two-earning families to work more frequently and longer.

Among the most damaging aspects of high marginal tax rates are their impact on the willingness to undertake economic risks. In particular, recent research has shown that tax rates have a profound influence on entry into entrepreneurship and entrepreneurial activity. Reducing marginal tax rates allows entrepreneurial businesses to grow faster, enables greater purchases of capital, and allows small business to hire additional workers and increase payrolls. Marginal rate reductions also improve access to capital and the vitality of the entrepreneurial sector.

For example, recent research by economists Douglas Holtz-Eakin and Harvey Rosen indicates that reducing the top marginal tax rate from 39.6 percent to 33 percent will raise the fraction of high-income small businesses that undertake a capital expansion by 12.5 percent, and raises the average size of the capital outlays by 11.9 percent.

Cutting the top marginal tax rate raises the fraction of high-income small businesses whose prospects are good enough to afford outside help by 12.1 percent. For existing employers, cutting the top marginal tax rate from 39.6 percent to 33 percent permits payroll growth of 4 percent, taking the form of both higher wages and more workers. The effects on capitalization, employment, and incentives of lowering the top marginal tax rate from 39.6 percent to 33 percent causes the sales of high-income small businesses to rise by 8.2 percent.*

Finally, a commitment to lower marginal tax rates should be viewed as part of our continued efforts to encourage young people to acquire education and skills.

It is important to emphasize that the benefits of lower marginal rates and lower deadweight losses accrue to the economy as a whole. For example, when entrepreneurs expand, small businesses purchase more capital, benefiting their suppliers. They hire more workers and increase their payrolls. In addition, their growth and innovation provides consumers with a greater range of products and choices.

The incentives provided by lower marginal tax rates are especially important for the top marginal tax rate. A large body of economic research has examined the adjustments, seen and unseen, to improved incentives – more days and hours of work, greater effort on the job, increased risk-taking and entrepreneurial activity, reduced tax-based financial engineering, and so forth – are summarized by the increase in taxable income induced by a cut in marginal tax rates.

Cutting the top marginal tax rate leads to the greatest response in taxable income. Research by Martin Feldstein – a former Chairman of the Council of Economic Advisers – indicates that the response of taxable income to increases in the "tax price"—one minus the marginal tax rate-- may approach unity. However, even those who find the most modest impacts indicate that the response is at least one-half of this size.

It is easy to see the virtues of reducing the top marginal tax rate on the identifiable entrepreneurs who face tax-based costs of decisions to expand their facilities, hire new workers, reward their best employees, and push their businesses forward. The evidence on the response of taxable income reflects the benefits of lower marginal tax rates on all forms of economic activity.

*Computations based on Douglas Holtz-Eakin and Harvey S. Rosen, "Economic Policy and the Start-Up, Survival, and Growth of Entrepreneurial Ventures," May 2001.

How does the President's plan measure up? First, the focus is on an across the board reduction in marginal tax rates – including reducing the top marginal income tax rate from 39.6 percent to 33 percent.

Second, the President's plan will encourage the saving and investment. By phasing out and eliminating the death tax, the plan reduces a tax on capital accumulation that has the highest marginal tax rates in the tax code. At the same time, by permitting non-itemizers a deduction for their charitable contributions, tax-free withdrawals from IRA for charity, and raising the cap on corporate charitable contributions, the President's plan will allow non-profits to compete more equally for the infrastructure to economic growth.

Third, the President's proposals will raise the accumulation of "human capital" at all stages of the life cycle. Expanding the generosity of the child tax credit will provide families additional resources to pay for education, childcare, and other costs associated with child rearing. At the same time, the President's proposals to reduce the marriage penalty will address both an issue of basic fairness, as well as lowering marginal tax rates on second earners. Finally, the proposed expansions of Education Savings Accounts will promote human capital investment in education.

Finally, the President's plan addresses as well the third component of sustained economic growth – increases in technology – by proposing to make permanent the Research and Experimentation tax credit.

Taken as a whole, the President's plan would have substantial beneficial effects on economic growth. Macroeconometric models focusing on the short run generally predict modest effects on aggregate demand growth of income tax reductions. Long-term equilibrium models that incorporate effects of tax reductions on incentives generally predict larger gains in output growth.

Thank you, Mr. Chairman, for providing me this opportunity to discuss the state of the economy and the President's proposals to enhance long-term economic growth and economic security. I would be happy to answer your questions.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20502

THE CHAIRMAN

July 31, 2001

Dear Senator Reed:

Many thanks for your letter of May 30, 2001, in which you posed some questions as follow-up to my testimony of May 23 before the Joint Economic Committee. I do apologize for the delay in answering your questions. We did not receive the letter until June 18, 2001 (via fax). The answers to your questions are enclosed. I would be happy to call on you to discuss these issues in greater detail.

Once again, I am sorry not to get you this material earlier. Please let me know if I can be of further assistance.

Yours sincerely,

R. Glenn Hubbard

The Honorable Jack Reed
Joint Economic Committee
Room 804
Hart Senate Office Building
Washington, D.C. 20510-6602

Enclosure

Question #1: On page 7 of your testimony you express surprise that many believe we cannot afford the President's tax cut. Yet the budget resolution, which has a smaller tax cut than the one in the President's plan, leaves inadequate resources for important priorities once the Social Security and Medicare trust funds are reserved.

- Do you agree with the budget resolution that the Social Security and Medicare trust funds should be reserved?

Answer: The President has clearly stated his intention to preserve the Social Security surpluses, and every dollar of Medicare taxes is being spent on Medicare. Nevertheless, I am sympathetic to what I perceive to be your concern over financing of Medicare. For precisely this reason, the Administration has unveiled a comprehensive medicare reform proposal designed to address the long-run solvency of the program. We look forward to working with Congress on this important initiative.

- The budget resolution has a cumulative surplus of $504 billion after reserving Social Security and Medicare. Where will the resources come from to address the alternative minimum tax (about $300 billion); meet the Administration's likely defense request ($300 billion); fund IDEA (S.1) ($149 billion); or fund the additional interest costs of new proposals? Which of these should not be funded in order to afford the tax cut?

Answer: Thank you for your concern over the structure of fiscal policy, which I share and applaud. As you know, the President's Budget provided a set of tax and program initiatives embedded in a sound overall budget setting. While the Administration has not yet completed its Mid-Session Review of the Budget, making it premature for me to comment on specifics, the President's commitment to sensible, responsible budgeting has not wavered.

- Treasury Secretary O'Neill has said that this tax cut is the first not the last. Where in the President's budget were the resources set aside to pay for these additional tax cuts? What other priorities would have to give way in order to make room for additional tax cuts?

Answer: I am pleased to work with Secretary O'Neill and commend his leadership within the Administration. It is best, however, for you to direct your requests for clarification to him directly.

- Do you agree with the experts who believe that fundamental Social Security reform will have substantial transition costs? Where in the President's budget were the resources set aside to pay for these transition costs while preserving the existing Social Security surplus for its intended purpose of funding benefits that have already been promised?

Answer: The Social Security system is on an economically unsustainable path. While the OASDI program is currently running cash surpluses of approximately 2.22% of payroll, the intermediate projections of the Social Security Trustees indicate that the program will begin to run cash deficits in 2016. Without structural changes to the system, these cash deficits are projected to grow at an unsustainable pace, exceeding $300 billion annually by 2035 (in constant 2001 dollars). In the existing system, these shortfalls must be financed through tax increases, benefit or other spending cuts, or the issuance of additional public debt.

The President has clearly stated in his principles of reform that benefits to current and near retirees will not be reduced. He has also made it clear that reform must include voluntary, individually controlled personal accounts. If personal accounts are to be implemented with no change in benefits to current and near retirees, as the President has stated, it will be necessary to simultaneously fund current benefit payments and the personal accounts. This resource requirement is often referred to as the "transition cost," although this name is misleading because it is not a "cost" in a true economic sense. Rather, it is the setting aside of real economic resources today to help meaningfully pre-fund future benefit payments.

The magnitude of the resources required to finance a transition depends on the exact nature of the reform proposal, such as the size of the accounts, the source of funding, and so forth. At this time, there is no specific proposal on the table. The Commission to Strengthen Social Security has met twice and has not yet begun to discuss its policy recommendations. Therefore, it would be premature to speculate on the size of the transition financing needs.

The President is firmly committed to using Social Security surpluses for Social Security, and in fact, has made this commitment one of his principles for reform. Historically, these surpluses have been credited to the OASDI Trust Funds, but this does not mean that these resources were set aside for the future in an economically meaningful way. As was pointed out in President Clinton's year 2000 budget, contributions to the Trust Fund "are available to finance future benefit payments and other trust fund expenditures – but only in a bookkeeping sense... They do not consist of real economic assets that can be drawn down in the future to fund benefits." The President is firmly committed to using Social Security surpluses for their intended purpose of funding benefits for current and future retirees, but this does not imply that crediting the Trust Fund is the only, or most effective, way to achieve this.

Question 2: You have been a strong critic of the standard methodology used to distribute tax burdens, arguing that sorting people according to their annual income provides a biased picture. Most people recognize that the United States' economic system is one of the most fluid in the world, with movement up and down the economic ladder. But is there not evidence that "permanent" or lifetime income is also distributed very unequally and that a large share of the benefits of the tax cut will go to those with high permanent incomes? Are a $25,000 waitress and a $250,000 corporate lawyer really people with roughly similar lifetime incomes who happen to be at different points in their career?

Answer: I am, indeed, skeptical of the distributional analyses that are exclusively focused on snapshot measures at a single point in time. Instead, it is useful to incorporate notions of economic mobility to our understanding of the distributional impacts of tax (and other) policies. The underpinnings of this view would require an extremely long response. Fortunately it is not necessary to do so, as the Treasury has produced an excellent study. ("U. S. Department of Treasury. Office of Tax Analysis: 1992. "Household Income Mobility During the 1980s: A statistical Analysis based on Tax Return Data. Washington, D. C: U.S. Department of Treasury"), a copy of which I enclose for your use.

Question 3: On page 7 of your testimony you say that the President's tax cut proposal is less than one-half the size of the Kennedy tax cut and roughly one-fourth the size of the tax cuts proposed by President Reagan. But aren't these comparisons misleading?

- How large is President Bush's proposed tax cut as a share of GDP?

- A Department of the Treasury study estimates that the fully phased-in cost of the Kennedy tax cut was 1.6 percent of GDP. Is this twice the size of the President's proposal, or even the smaller tax cut the Congress is likely to pass?

- The Center for Budget and Policy Priorities uses the same Treasury study to estimate that the cost of the Reagan tax cut was 2.1 percent of GDP. Is this roughly four times the size of the Bush plan?

Answer to all parts of #3 above: The key feature of my remarks is not the specific numerical comparisons, but rather that the President's budget outlines a tax cut that requires only 1.2 cents in each dollar of GDP over the budget window, and that this should provide beneficial economic effects while preserving Social Security and Medicare, allowing for prudent increases in other programs, and otherwise maintaining budgetary discipline.

Question 4: Why is the Administration pursuing an energy policy of increasing supply rather than conserving demand? Hasn't technology not only made it possible for energy producers to produce more with less pollution, but also for consumers to buy products that are just as functional but use less energy, or for producers to deal more easily with higher fuel efficiency or emissions standards?

Answer: In sculpting our energy policy, the Administration has sought the most efficient way to bring us out of the imbalance between supply and demand that has caused higher energy prices. This does involve addressing both the supply of and demand for energy. As you point out, technology has enabled *both* lower cost, cleaner production, and less expensive means of meeting existing consumer needs while using less energy. As you can see in the National Energy Policy document, there are several recommendations that focus on expanding conservation by increasing funding for energy efficiency programs, encouraging the development of fuel-efficient vehicles, creating tax credits to encourage consumer conservation, and expanding DOE conservation programs. These recommendations can be broken down into two groups: those that promote the diffusion of existing, cutting-edge technology for increased energy efficiency; and those that promote emerging technologies. Recommendations targeting the diffusion of existing technology include incentives for combined heat and power projects, and extensions to the Energy Star program. Recommendations promoting emerging technology include the recommendation for the review of current funding and historic performance of energy efficiency research and development programs, with an eye towards improving their performance in generating new or improved energy efficiency technologies.

As you indicate, addressing our Nation's energy problems require us to correct any market failures that may be impeding either the provision of additional supply or the introduction of more energy efficient technologies. Indeed this balance is reflected in the recommendations presented in the National Energy Policy report.

Question 5: You claim in your testimony that the benefits of marginal rate reductions accrue to all citizens through business expansion that leads to greater employment and wages. What evidence is there that the Reagan tax rate reductions produced these gains for everyone? What happened to median household income between the business cycle peaks of 1979 and 1989? What happened to the distribution of real after-tax income?

Answer : The 1980s were an exceptional period in the nation's history and provide an example of how a solid business expansion generally improves the well being of all citizens. During this period, we not only achieved one of the longest expansions on record but also saw American living standards begin to rise again after the relatively sluggish period in the 1970s. During the 1980s, real per capita income—one of the broadest measures of economic well being—rose as did real family income. As well, nominal and real median household incomes rose.

These developments reflected the fact that labor market conditions improved markedly in the 1980s as real compensation rose and employment opportunities grew. In fact, nearly all regions of the country shared in the benefits and unemployment rates dropped for all major demographic groups. To be sure, you are correct in noting that the real after-tax income distribution shifted somewhat. But, much of the shift reflected the longer-term economic trend toward higher returns to education and experience.

In addition, the durability of the expansion and of the income gains in the 1980s reflected advances in private sector productivity. It is not a coincidence that the 1980s witnessed a restoration of America's competitiveness—especially in manufacturing industries. While the private sector played the biggest role in the nation's success during the period, the Reagan economic plan—especially the tax plan—helped set the stage for these developments.

Question 6: Your statement did not mention that the tax cut would lower national saving in the long run. A permanent decline in national saving, for whatever reason, permanently lowers the economy's potential output. Does it matter for the economy whether the decline in national saving stems from a reduction in a federal surplus or from an increase in a federal deficit? In other words, if it was crucial to U.S. growth that we reduce the federal deficit, an effort that took most of the last decade, why does the Administration not believe it inimical to economic growth that we use the surplus to finance a tax cut rather than eliminate the national debt?

Answer: I agree that more saving is generally associated with higher growth. But the saving path in the Federal baseline—that is without the tax cut—was not likely to come about. And if it did occur, it would have presented the country with formidable problems.

First and most important, without the tax cut, the surpluses would likely be much smaller than projected in the current-services baseline. Large and rising surpluses would have tempted the future Administrations and future Congresses to spend more. Large projected surpluses would have led to bigger government, rather than higher savings and investment.

Second, the current-services path of debt elimination was too swift, necessitating either Federal ownership of business or the buy back of Treasury bonds before maturity. By the end of FY 2000, the Federal government had $3.4 trillion of outstanding debt held by the public, but only $2.2 trillion of this debt would have come due during the 10-year budget window. It would have cost American taxpayers an additional $100 billion or so to retire this debt before maturity. The higher prices would have been needed to coax the holders to sell their increasingly scarce holdings of Treasury securities. With the tax cut the Treasury will not need to buy back Federal debt before maturity. Even so, the debt held by the public will be reduced.

Of course Federal purchase of private securities (and the accumulation of a Federal asset) is a possible—but ill-advised—alternative to buying back Treasury securities. Under such a plan, the Federal government would own capital that would be better left in the private sector; the Federal government is not a good business manager.

Question 7: You claim that cutting the top marginal tax rate will be particularly helpful to small businesses. Yet only a small fraction of true small businesses pay the top marginal rate. Wouldn't lowering the 15 percent tax rate be more helpful to small businesses?

Answer : I agree that lowering the 15 percent tax bracket will help small businesses. It is also important to point out that cuts in the top marginal tax rates will be particularly helpful to many small businesses and will have important consequences for the economy. Lower tax rates will increase cashflow, which will, in turn, increase the demand for investment and labor. Lower tax rates also provide an incentive for wage earners to become entrepreneurs and for existing entrepreneurs to expand their scale of their operations.

Overall, the reduction in the tax rates will affect the majority of small business owners. Of the nearly 24 million flow-through entities (e.g., sole proprietorships, farm proprietorships, partnerships, S Corporations) in 1998, roughly three-quarters will benefit directly from the tax cut. For the top tax tiers, over a million taxpayers will benefit from cuts in the 36 percent and 39.6 percent rates. However, I should note that nearly 2 1/2 million taxpayers in these tax brackets will receive no tax benefit because of the alternative minimum tax (AMT).

Question 8: Since the time CBO published its most recent projection, the unemployment rate has risen by half a percentage point and the Federal Reserve has cut its target for the federal funds rate five times in order to stimulate the economy. At the same time, investment in equipment and software have fallen and productivity declined. Do these developments make you more or less confident that the surplus over the next ten years will be as large as projected?

Answer: The economic news that you cite (the Federal Reserve's interest-rate cuts, the declines in equipment and software investment, and the decline in labor productivity in the first quarter) are all interesting short-run developments. But it tells us little about growth over the ten-year budget window.

Long-term budget planning should be based on the long run trend in output, and it is important to separate the cycle from the trend. The economic slowdown that we are experiencing is a perturbation of the cycle—not the trend. Although economic forecasters have lowered projected economic growth in 2001, they have raised their estimates of growth in 2003. On balance, the consensus forecast of the long-run <u>level</u> of real GDP has been revised down only slightly.

Even with the slight downward revision to the consensus level of real GDP, the Administration's projection remains conservative. The Administration estimates the long-term growth rate of real GDP at about 3.1 percent—0.2 percentage point below the consensus of economic forecasters.

The near-term economic slowdown likely will reduce the projected increase in the budget surplus in the short-run. But the effect on the projected total surpluses over the ten-year budget window will be small, as the Administration's long-term economic assumptions are reasonable, and even conservative relative to the Blue Chip consensus.

Question 9: Is the Administration concerned about the risks of a sharp collapse in the exchange value of the dollar as well as the consequences of such a collapse for domestic saving and investment? What are the Administration's policies for the dollar:

Answer: As Secretary O'Neill has said, "We are for a strong dollar, and we are going to continue to be for a strong dollar ... it has served us very well."

Question 10: Someone working full time at the current minimum wage would not earn enough for a parent and child to be above the poverty level. What is the Administration's policy on the minimum wage? If not the minimum wage, what other policies does the Administration support to make work pay for low-income working families?

Answer: Any increase in the minimum wage needs to recognize differences across states and provide for state flexibility because all states have not shared equally in prosperity. The Administration's tax cut will help working families.

Question 11: Regarding the argument on the so-called "deadweight losses," or inefficiency that the tax system generates, isn't it true that at least some deadweight loss is unavoidable in a tax system that isn't completely arbitrary in nature (that is, a system where tax burdens rise with income, where credits and deductions are given for certain types of behavior, and where certain forms of income are given preferential treatment over other forms)? And since the President's plan doesn't do anything to change the most inefficient parts of the federal tax system (such as the AMT, the corporate tax structure, and the various phase-outs), will it really be that effective at substantially decreasing deadweight loss? And by how much?

Answer: While it is true that no real-world tax system has been devised to eliminate all the "dead-weight losses," the President's tax plan made significant progress toward improving the efficiency of the U.S. tax system. Without a doubt, lowering marginal tax rates permanently while preserving a surplus reduces dead-weight losses. But let me also say that I agree with the premise of your question. We need to look more closely into the federal tax code to find and ultimately eliminate inefficient tax provisions. I look forward to the opportunity of working with you in the future to explore these possibilities.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS

August 1, 2001

Senator Jack Reed

Please replace this page in the enclosure to the letter to you dated July 31, 2001 from Dr. Glenn Hubbard in response to your letter of May 30, 2001.

Thank you.

Alice Williams

Alice Williams
Executive Assistant to the Chairman

Attachment: corrected page

the tax cut will go to those with high permanent incomes? Are a $25,000 waitress and a $250,000 corporate lawyer really people with roughly similar lifetime incomes who happen to be at different points in their career?

Answer: I am, indeed, skeptical of the distributional analyses that are exclusively focused on snapshot measures at a single point in time. Instead, it is useful to incorporate notions of economic mobility to our understanding of the distributional impacts of tax (and other) policies. The underpinnings of this view would require an extremely long response. Fortunately it is not necessary to do so, as the Treasury has produced an excellent study. ("U. S. Department of Treasury. Office of Tax Analysis: 1992. "Household Income Mobility During the 1980s: A statistical Analysis based on Tax Return Data. Washington, D. C: U.S. Department of Treasury").

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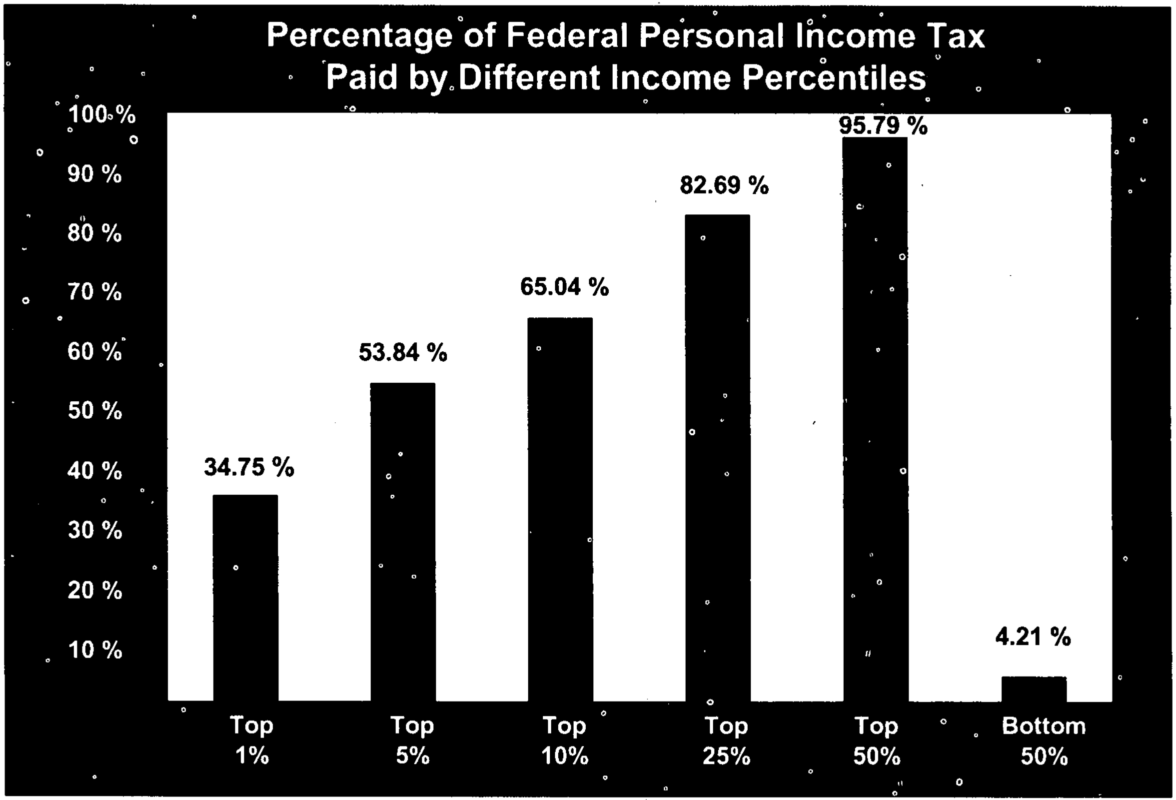
Percentage of Federal Personal Income Tax
Paid by Different Income Percentiles
100 %
90 %
80 %
70 %
60 %
50 %
40 %
30 %
20 %
10 %
34.75 %
53.84 %
65.04 %
82.69 %
95.79 %
4.21 %
Top 1%
Top 5%
Top 10%
Top 25%
Top 50%
Bottom 50%