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THE ADMINISTRATION'S GROWTH AND JOBS PLAN

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED EIGHTH CONGRESS

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CONTENTS

OPENING STATEMENT OF MEMBER

Senator Robert F. Bennett, Chairman 1
Representative Pete Stark, Ranking Minority Member 3
Representative Jim Saxton, Vice Chairman 5
Representative Paul Ryan 6

WITNESS

Statement of the Honorable R. Glenn Hubbard, Chairman, Council of Economic Advisers 8

SUBMISSIONS FOR THE RECORD

Prepared Statement of Senator Robert F. Bennett, Chairman 30
Prepared Statement of Representative Pete Stark, Ranking Minority Member 32
Prepared Statement of Representative Jim Saxton, Vice Chairman . . 35
Prepared Statement of the Honorable R. Glenn Hubbard, Chairman, Council of Economic Advisers 37
Prepared Statement of Senator Edward M. Kennedy 52

The Administration's Growth and Jobs Plan
Thursday, January 30, 2003

Congress of the United States
Joint Economic Committee
Washington, D.C.

The Committee met, pursuant to notice, at 10:03 a.m., in Room 628, Dirksen Senate Office Building, the Honorable Robert F. Bennett, Chairman of the Committee, presiding.

Present: Senators Bennett, Collins, Sarbanes, and Reed; Representatives Saxton, Stark, and Ryan.

Staff Present: Donald Marron, Jeff Wrase, Christopher Frenze, Robert Keleher, Brian Higginbotham, Colleen J. Healy, Dianne Preece, Wesley Yeo, Wendell Primus, Chad Stone, Frank Sammartino, Diane Rogers.

OPENING STATEMENT OF ROBERT F. BENNETT, CHAIRMAN

Senator Bennett. The Committee will come to order. We welcome everyone here to the first hearing of the Joint Economic Committee of the 108th Congress, and I am happy to have the privilege of chairing the Committee for the next two years.

I want to begin by thanking Representative Saxton for the fine work he did as Chairman in the previous Congress, and I look forward to working with all of the Members of the Committee, on both sides of the aisle. I hope we can continue this Committee's tradition of working together in the utmost courtesy and civility, even though I know we will also continue the tradition of being very firm in our somewhat differing views of the economy and policy.

We are pleased to have as our distinguished guest Dr. Glenn Hubbard from the Council of Economic Advisers (CEA). Dr. Hubbard has served the President ably for the past two years, and we're grateful, Doctor, for your commitment to public service.

It is fitting that our first hearing features the head of the CEA, because the Committee and the Council were created together in 1946. They have worked hand-in-hand over the years to provide timely, and we hope objective, economic analysis for our respective branches of government. My staff and I have enjoyed working with the CEA, and I expect this cooperation will continue.

As Federal Reserve Chairman Alan Greenspan recently testified before this Committee, the economy is currently going through a soft patch, and the lack of robust, sustained economic growth has been a frustration to everyone.

The proper role of the government in alleviating a sluggish economy and accelerating the nascent recovery is a difficult one, and it sometimes seems that there are as many different answers, as there are economists.

The primary focus of today's hearing is the Bush Administration's proposal to boost the economy in the near term and at the same time provide a solid foundation for long-term growth. The proposal would accelerate tax cuts that Congress has already approved, moving their effective dates from future years into the present one, while reducing marginal rates and eliminating the marriage penalty, increasing child tax credits, and providing families with some relief from the alternative minimum tax.

In addition, the proposal would triple the small business expensing limit for new capital investment, provide states with funds to establish individual reemployment accounts, and eliminate the double taxation of dividends.

This tax cut proposal is a bold one, and one that is sure to increase the budget deficit in the short-run. However, I do not think that the primary factor in judging the policy ought to be its impact on the near term deficit. I think one lesson we've learned in the last 30 years, through both Republican and Democratic Administrations, and Republican and Democratic Congresses, is that solid economic growth is a wonderful elixir for budget challenges.

In my view, the current budget deficit arises primarily because that solid growth was interrupted at a time when we had dramatic increases in spending, much of it brought on by the aftermath of the 9/11 tragedy.

We've seen significant increases in outlays, first for the rebuilding of New York, then for the war on terror, then for homeland security, and then for preparations for possible action in Iraq. Singling out the tax cuts already enacted as the sole cause of the deficit, as some have done, strikes me as simplistic. Thus, I'm very much interested in how Dr. Hubbard and his staff believe the President's proposal can get us back on the growth path in both the short-run, and more importantly, the long- term.

The most ambitious part of the growth package is undoubtedly the removal of the double taxation of dividends, and I'm sure that many of the questions today will be about the particulars of this part of the President's plan. There are many different ways to structure tax reform so as to eliminate the double taxation of dividends, a pernicious distortion of the tax code that has been reduced or eliminated in almost all of the other developed economies.

I welcome the opportunity to have Dr. Hubbard explain some of the details of the tax cut and the choices made in constructing the plan.

We also welcome Dr. Hubbard's thoughts on the current state of the economy. This morning's GDP report suggests that the economic soft patch is still with us. We avoided having the fourth quarter dip into negative territory, so to that extent, this morning's number of a positive growth of 0.7 percent is good news. Nonetheless, it is substantially less than we would hope, so to that extent, it is bad news, and it's a disappointing number.

We need to do what we can to produce more robust and rapid growth in 2003, as many economists are forecasting we will have, so I will be interested to learn what Dr. Hubbard has to say and whether or not he

shares the enthusiasm that some of the forecasters have and hear his thoughts on the challenges and risks that face the U.S. economy.

Now with that, I think we will turn to Mr. Stark, who is the de facto Ranking Member of this Joint Committee, and then we will hear from Mr. Saxton, who is the Vice Chairman of the Committee.

After that, I would ask those Members who come to limit whatever opening statements they might have to five minutes, and then we will go to – pardon me, opening statements to three minutes – then we will go to the round of questioning after we hear from Chairman Hubbard, and I would ask all Members to stay within the traditional five-minute limit.

Mr. Stark, we welcome you to continued service on this Committee now in your role as Ranking Member, and be happy to hear what opening statements you might have.

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

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Well, thank you, Mr. Chairman, and congratulations on your prestigious new appointment. Mine, people have often asked me, what does mean to be the Ranking Member? And I know it's just like being the parsley on a platter of fish.

(Laughter.)

But I enjoy the privilege and prestige of it and want to thank my colleague, Mr. Saxton, for his past two years of service to this Committee. He did a good job, and I know that Chairman Bennett, you will continue that tradition.

I thank you for having this hearing. All indications are that Dr. Hubbard was the key architect in this economic plan that's being presented to us by the Administration, and I'm anxious to hear more about his ideas and how he would respond to questions and criticism.

Two years after the start of our recession, the economy is still in a slump. We're not creating jobs. We've got tremendously weak growth in GDP. Unemployment is at an eight or nine-year high of around 3 percent. And economic growth is miserly if it exists at all.

The economy is not delivering any jobs. We're waiting for business to start investing and rehiring, and we're hoping that the consumer will start spending so we don't slip into a deeper recession.

I wish I could say that the President had presented us a plan that would address the problems in the economy, but he's not. We've mostly put money into the hands of those who don't need it, and I think we should have a plan that gets people spending immediately. The President has proposed to eliminate individual income tax on dividends paid by corporations and speed up rate cuts to a relatively small number of very high income taxpayers.

I see three problems with the President's plan. It doesn't provide stimulus in the near term, it's fiscally irresponsible, and it's unfair. It's going to provide maybe $35 billion in the first year, and in a package that

costs $674 billion over ten, that seems wrong – the curve just seems to be drawn improperly there.

He relies almost exclusively on tax cuts, ignoring government spending which can have a direct and immediate impact on jobs and incomes. One of the obvious ones would be health care. The President's plan doesn't address the question of 40 million Americans without health insurance, and I think there's no question that spending on health care is one of the fastest job-creating opportunities in any community.

There is very little relief for the states, much of the problems of which have been caused by change in our tax policy. There's no money for child care and other support that would help single mothers and the millions of people whose unemployment has not been addressed as their unemployment benefits are expiring and they're having trouble finding a job.

The plan drains budget resources, making it in my opinion fiscally irresponsible, and as I said, those budget resources could be put to better use. I mentioned Medicare. We could spend the $13 billion that the President has touted for his *Leave No Child Behind* proposal. He just didn't buy them a ticket to get on the bus to come along. So I think money could be better spent there.

The proposal is unfair. I suspect my tax cut will amount to $40,000 or $50,000. I'm sure Chairman Bennett will get almost $90,000 in his tax cut, and the average family is going to receive very little, a buck or two.

Senator Bennett. If I may, I only wish that were true.

(Laughter.)

Representative Stark. Well, I just judged that by your excellent suit.

(Laughter.)

I figured if you could have a suit like that, you must be able to afford it.

Representative Saxton. What about my suit?

(Laughter.)

Representative Stark. I know that here's a man of the people like me, and we won't get much of a tax cut.

(Laughter.)

Really, I would like to see, as our leader on the House side, Nancy Pelosi, and the leader Mr. Daschle, on the Senate side, have talked about a plan that provides perhaps $140 or $150 billion in the first year, and hopefully would put people back to work immediately. I know that's where our differences will come, and I look forward to seeing whether and how we can put that money immediately to work.

I suspect that every community in every Congressional District in the country has on its shelf a public works project that would put people immediately to work. Highways in Wisconsin, I might suggest, Mr. Ryan. Schools in New Jersey. In Utah every community has an important project, immediately putting people to work, immediately providing something useful in our communities, I think that's where we should direct our money or education as you choose.

I'd like to see us go back to the eighties when we saw deficits balloon, but there was a difference. President Reagan recognized that the tax cut that he passed in 1981 was excessive, and he scaled it back. Perhaps that's what we should think about now, and I look forward to your testimony, Dr. Hubbard, and how it addresses those concerns.

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

Senator Bennett. Mr. Saxton, again we thank you for your service and your period as Chairman, and I'll do my best to try to rise up to your level of excellence.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

Representative Saxton. Well, Senator Bennett, Mr. Chairman, I congratulate you on assuming the responsibilities and the pleasures of being the Chairman of this Committee. I believe very firmly that this Committee has served a very useful purpose over the last decades, and have enjoyed very much chairing it both during the 105th and the 107th Congress and working with Pete Stark and yourself and others.

And in particular, let me just say what a pleasure it is to welcome Chairman Hubbard back before the Committee again. People like Chairman Hubbard and Alan Greenspan, who come before the Committee, have been a great help in helping us to understand, while we don't always agree, to understand the Administration's position, and today we'll be looking forward to Dr. Hubbard's insights, which will be helpful I'm sure once again.

Let me just say that a review of the data shows that the economy has not yet fully rebounded from the slowdown that began in the middle of 2000. Although GDP growth was about 3 percent during the first three quarters of the year, it lagged in the fourth quarter. Consumption has held up quite well until the last quarter, but weakness in business investment continues to be a feature of the slowdown. Employment has also been weak, with manufacturing employment, for example, falling for 29 consecutive months since the summer of the year 2000.

The President has proposed to accelerate already scheduled tax reductions in individual marginal income tax rates and the marriage penalty, provide a dividend exclusion for individuals, and expand expensing of investment for small businesses, among a variety of other things.

During 2001, many economists noted the timeliness of the first installment of tax relief, given the fact that the economy had slipped into a recession. The current concerns about the pace of the economic expansion indicate that accelerated tax relief now would also be appropriate. The end of double taxation of dividends would also reduce the bias against savings and investment in the tax code, and enhance the prospects of economic growth over the long run.

Unfortunately, opponents of the President's tax proposal have misrepresented it as skewed toward the affluent. However, this argument is typically based on incomplete information taken out of context. As I have pointed out before, disclosure of the shares of taxes paid by each

income group before and after a tax relief plan goes into effect is usually not made by such critics. Such information would demonstrate that the proposition of tax relief is mostly driven by shares of taxes paid before tax relief becomes effective, and usually subsequent changes in total tax shares are quite small.

Another issue related to evaluating the impact of tax relief is income mobility. Over ten years ago, this Committee asked the Treasury Department to provide an analysis of mobility of tax filers over an extended period of time. In the last Congress, I requested an updated examination of this critically important issue, as such information would be valuable to policymakers now in determining what happens to various people in various income categories as they move from one quintile to the next.

There are those who persist in viewing the U.S. economy as a sort of caste system in which people are cemented into a particular income class forever. It's simply not so. Data on income mobility demonstrate a much more flexible and dynamic reality characterized by fairly high degrees of income mobility. That is a key element in our economic system.

Once again, Chairman Hubbard, I want to just take this opportunity to thank you for being here with us once again, and we look forward to your testimony.

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

Senator Bennett. Thank you very much, Mr. Saxton. Mr. Ryan, we welcome you to the Committee, and look forward to your participation. Do you have some opening comments for us?

OPENING STATEMENT OF REPRESENTATIVE RYAN

Representative Ryan. I do. Thank you, Mr. Chairman. It's not often that a junior Member gets to engage in opening statements. In the House, they usually just do the Chairman and the Ranking Member, so I'm going to have to take advantage of this opportunity.

Senator Bennett. Keep your eye on the clock.

Representative Ryan. Yes, I will.

(Laughter.)

Thank you. I'd like to make just three quick points. You're going to hear this kind of rhetoric back and forth for quite some time. On the demand side of the economy, it's very common that the other side of the aisle will talk about sort of the Keynesian demand-side stimulus. If that is what we're interested in doing, I would argue that is not what the economy needs right now.

The Bush plan has more of it. If you take a look at the Democrat plan, it's $300 once. You get a check one month for one year. The Bush plan, 92 million Americans get $1,100, not this year, but every year thereafter. So even if you're of the opinion that this economy needs demand-side stimulus, there's more of it in the Bush plan.

On the issue of what's the best for the states. This one I grapple with quite often. My Governor is facing a $4 billion biennial deficit. It's a big problem in our municipalities. And I would argue that people going back to work paying taxes helps not only the Federal Government, but it

actually helps the states and the municipalities, because their tax revenues will increase. So economic growth is the ball that we need to keep our eyes on. That is the best thing for the states; given that more government spending is not the solution to our economic problems.

The basic three components of the definition of Gross Domestic Product(GDP) are consumption, investment, and government spending. Consumption, relatively speaking, has done quite well. It's the reason why, arguably, we had positive economic growth last year. Now it went down a little bit in the last quarter, and I think our GDP statistics as of this morning for the fourth quarter are about 0.7. So clearly, our economy needs growing and needs helping.

Government spending. We're at an all-time high. We're spending more in the Federal Government than we ever have before in the history of this country, essentially. So the idea that more government spending will fix our economic problems belies the facts. If government spending was the answer to growing our economy, we wouldn't have economic problems today. We wouldn't be coming out of a recession slowly.

So the problem with the economy and the problem with what is hurting Gross Domestic Product is investment. Investment is declining. Investment has been declining for eight consecutive quarters. We may see some signs of recovery on the investment side, and that is why, appropriately so, the basic components of this tax plan is focused on reviving investment.

And one of the most hostile aspects to investment is the tax code. We have basically two functions in government – this is my opinion – that we can do to help grow the economy: Monetary policy, which the Fed Chairman is almost out of bullets on that one, and tax policy. And of the areas in tax policy where we really hurt investment, it is how we double and triple tax capital. And one of the most obnoxious provisions in our tax code that double taxes capital formation, that puts a higher price on investment, is the way we double tax dividends. Because the effective tax rate on dividends in so many ways exceeds 60 percent.

And so when we see a huge problem in the double taxation of dividends and how it raises the price of investment, it goes in saying that as we reduce this double taxation on capital, as we reduce that tax, we reduce the price of investment, and we can help investment flourish, grow, and that in turn helps businesses expand and create jobs. That will help the states. That will help the Federal Government. But more importantly, that will help all of our constituents who are hard at work looking for jobs.

With that, I conclude. Thank you, Chairman.

Senator Bennett. Thank you very much. Well, Dr. Hubbard, you've heard the kind of argument that probably is going to go on, but we turn to you for some light and understanding and background on the President's proposal. And once again, we thank you for your being here today, and we thank you for your commitment to public service.

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

Dr. Hubbard. Well, thank you very much, Mr. Chairman and Mr. Stark and Members of the Committee. I'd like to begin, Mr. Chairman, by thanking you and of course Mr. Saxton as well for the ongoing privilege CEA has of working with the Committee.

In pretty short order we'll also be delivering to you the President's economic report and look forward to discussing that with you as well.

I really just want to touch on three themes in my oral remarks for you, Mr. Chairman, and really key in on a picture for each. One to talk about the golden goose, second to talk about the problem, and third to talk about some benefits of what the President's proposing.

Senator Bennett. If I may interrupt you, with unanimous consent, your formal statement will be included in the record.

Dr. Hubbard. Thank you. Thank you, Mr. Chairman. I wanted to start out with the story that we've all got to keep our eye on that I just alluded to as the golden goose. Over the long term, what determines all of our living standards is our nation's productivity growth. And we have some good news here in the long term that we have seen an acceleration in productivity growth in the United States.

This is good news not just over time for the United States, it's actually a statement about how well America is doing vis-a-vis our trading partners who have not received the same kind of increase in productivity growth. That reflects in very large part the flexibility of the private sector in the United States, and attempts by public policy to make sure that we have the right environment for productivity growth. So in the long term, that's what we have to focus on.

In the short term, as came up in the opening remarks, the economy is in a soft patch. The data that we just received this morning indicated that real GDP growth for the fourth quarter was very modest, a positive number, but very modest, .7 percent, well under what we believe the economy's potential growth to be.

Within that, we believe that investment has played the lion's share of the story. I would like to turn if I could to the second chart. If you think about the economic situation in the current recovery, the household has been the star, both during the downturn and in the upturn that we have. Investment is the problem. What this picture does is show you how investment behaves both during a recession, on the left side of the chart, and in the recovery, on the right side of the chart, the solid line being a typical recession over the postwar periods. So the typical recession. We'd had good times before. Investment is very cyclical. A decline and then a quick recovery.

The most recent recession is not typical of the post-war period. It was a period in which the economy had accumulated too much capital. That is, we overestimated the profitability of capital in the economy. We're all familiar with new economy stories, overvaluation in the equity markets and so on. So we had – the red line meaning the current recovery and recession – we had more investment, and then we had a much sharper decline. So investment really does remain the problem.

We believe in the Administration that not only is investment a key to understanding the current outlook – I think the data make that obvious – it is a key to understanding what to do about it.

In thinking about the downside risks to the economy that were on the President's mind, a key one was the prospect of a delayed investment recovery. Most of the private sector forecasts that are relatively optimistic assume a very timely investment recovery. And I think that is still a reasonable scenario in the economy.

However, I must tell you, as I talk to business executives around the country and quiz economists on the uncertainty in their forecast, I remain very worried about the timing of the investment recovery. That is in large part because business people have assigned very high hurdle rates or bars to jump over for new investment projects, and I think that is a key risk that our economy faces.

There of course is also a risk on the consumer side. We have seen a substantial deterioration in household wealth with declining equity markets that's been offset in part by positive news on the housing front, but on balance, the household sector has lost wealth, and that lost wealth may affect consumption through household's increases in saving to rebuild.

With these risks to the short-term outlook in mind, the President advanced a very bold proposal to enhance long-term growth while providing near-term support against these downside risks. You all know the elements of the President's proposal, but I think what's important is the mapping of those elements to the downside risks.

So let me start with what I identified as the diagnosis or the problem that the President saw and was trying to fix, first on supporting investment. There are at least three ways in the package of proposals that the President submitted that we have a very pro-investment shift in policy. One obviously is the elimination of the double tax on corporate income, and I'll come back to this.

Second is raising the expensing limits for small business, a very dramatic reduction in the cost of capital for small business owners. And third, the advanced reductions in marginal tax rates. Remember that a great many small businesses pay tax at individual rates. So this isn't just a matter of putting money in people's pockets, it's a matter of lowering the cost of capital for investment and for job creation in small businesses.

We believe that the most immediate effect of ending the double taxation of corporate income, which we believe is a very important part of the President's proposal, is to lower the cost of capital faced by firms in equity markets. This proposal is often discussed as to who gets dividends. I would submit to you while that's a dimension of the problem, it is not the most interesting. The most interesting is the dramatic effect of this proposal on the cost of capital for business investment.

We've estimated at the Council, depending on assumptions you make on the type of equipment, the way in which it's financed, costs of capital would fall by between 10 and 25 percent. For those who would say that this is not a short-term measure, let me restate it in the language that's

familiar in stimulus debates – investment tax credits. The elimination of the double taxation of corporate income would be equivalent to an investment tax credit of between 4 and 7 percent. Gentlemen, that is a very, very big tax cut for investment.

In addition to the economic efficiency gains which economists talk about, which were very much on the President's mind, I think it's important to acknowledge the very important benefits in terms of corporate governance. By switching to a tax system that does not reward financial engineering, that does not reward leverage and possibly excessive retention of earnings, there is a major improvement in transparency in corporate America.

The President's goal in addition to the gains in investment was that business people should be making business decisions based on their business judgment, not on the tax code. And when the American people as the owners of companies look at earnings, they have a right to know that those earnings are transparent and accurate.

In addition to the double tax, as I mentioned before, the President's proposals to dramatically increase expensing are very much pro-capital accumulation.

I also identified consumption in the diagnosis. Here the President's tax cut is dramatic. The change in calendar year liability for 2003 is almost $100 billion. The Treasury believes conservatively it can get $60 billion out the door. As was observed in the opening remarks, that is the down payment on a long-term tax cut. We expect that to have quite a significant effect on spending.

A typical family of four with two earners making $39,000 would receive $1,100 in relief under the President's plan.

Again, the fact that this is a long-term tax cut is very, very important. Temporary tax changes have very modest effects on spending, if that is indeed their goal.

The President of course has been keenly attuned to job growth. We all know that in addition to the recession's atypical feature in investment of jobs have not recovered as fast as a typical recovery would have them. In addition to the pro-growth features of the President's plan, he has also recommended $3.6 billion in block grant funding for personal reemployment accounts, which are designed to help individuals master their own training initiatives and get back to work more quickly.

Now how will this affect the economy? First let me tell you a story, and then I'll show you a picture. We tend to think in Washington sometimes about the very short run, and I'll talk with you about that. But it is important to understand again that what we're trying to do is also things that raise our economy's capacity to grow. And in that respect, the elimination of the double taxation of dividends is particularly important.

In economics, we know that who writes the check to the IRS has very little to do with who actually bears the burden of the tax. In the case of the double taxation of dividends in a growing economy, much of the burden of the tax is borne by workers, all of us, in our wages and incomes. Why is that so? The double tax decreases capital accumulation. That's less for each of us to work with in our jobs. Ultimately that lowers

our productivity and our wages. The President's proposal sets that in reverse and is very much aimed at raising wages and incomes, not just dividend payouts.

In terms of effects on the national saving and budget balance, we believe that what the President has suggested does not significantly worsen the government's fiscal position. There are two elements in the current debate over deficits that I think are very important. Both have to do with what do you do about them. The first is spending restraint, which the President has spoken of and will be evident in the budget as it comes to you next week. And the second is the promotion of economic growth.

I like to think in terms of a fiscal anchor. What could I look at to tell me over the next several years where we're headed in fiscal policy. To me as an economist, things like the debt-to-GDP ratio or thinking as a household or business would, debt service burden, say debt service over spending. Both of those, including the President's proposal, will be showing a downward trend over the next decade.

Let me conclude with the third picture if I might. The President is clearly aimed at improving the prospects for recovery. That's not just in GDP, that's in all of our jobs and our incomes, and for long-term growth. The diagnosis of business investment provides the light to the policy.

In this chart, we looked at the percentage difference from our baseline forecast for what the President has proposed, so we believe that we could get just under a percentage point higher GDP growth in 2003. This is cumulative in the level of GDP, so adding another .8 to that, we're getting 1.7 percent higher in '04, 1.8 in '05, and continuing increases in the level of GDP helping American workers going back to that first picture to sustain their potential.

If I might, Mr. Chairman, in ending my remarks make a comment about the budget as well. These changes in GDP, the level of GDP, are permanent. That means of course that the higher incomes each year translate into higher revenues each year. In thinking about the President's proposals, most of these are front-loaded. That is, they are the rate cut accelerations, the long-term piece being the dividends. And I would urge you as you contemplate that proposal in purely budget terms to compare the economic benefits with the proposal's cost.

Thank you very much, Mr. Chairman.

[The prepared statement of Dr. Hubbard appears in the Submissions for the Record on page 37.]

Senator Bennett. Thank you, Dr. Hubbard. Before you take that chart down, let me be sure I understand it. The growth rate, the annual growth rate in 2002 with the numbers we got this morning, comes out at about 2.7 percent?

Dr. Hubbard. Correct.

Senator Bennett. 2.75. Is this saying that the .9 goes on top of the 2.75?

Dr. Hubbard. The .9 is relative to our internal forecast for 2003, which will be part of the President's budget. So they'll be released to you on Monday. So relative to our forecast, we believe that we could get an extra nine-tenths of a percent GDP growth.

Senator Bennett. Well, yes. But specifically, so that the non-economist can understand it. If we are at 2.75 now, you are forecasting that we will be at 3.65 next year?

Dr. Hubbard. If the baseline were 2.75, you would add that to the baseline. So this is a very, very large change. The economy's potential growth is something like 3 percent is a way of scaling it for you.

Senator Bennett. Okay. But again, so that I can get it, 2.75, that's what this morning's numbers are saying this year will be? And you're saying with an 0.9 as the growth effect of this package, that next year would then, simple math, would be 3.65 next year?

Dr. Hubbard. Well, not quite. It would be adding to whatever the forecast is for next year, but that's quite close. So, yes, that's the increment. That's the extra GDP that our economy gets.

Senator Bennett. Okay. So if in fact we are 3.65 next year, that's a very good year.

Dr. Hubbard. That would be a very good year indeed, Senator. Keep in mind, there are a number of downside risks to the economy which made us do that, and all forecasts are uncertain, but we believe that even with that uncertainty, this extra will help us get to the numbers you've suggested.

Senator Bennett. I understand uncertainty. But if we then take 2.75 as our base and we add 1.7, you're up in very, very tall cotton at that point in 2004.

Dr. Hubbard. A little too tall a cotton.

Senator Bennett. Yes. That's why I want to get the --

Dr. Hubbard. This is the level of GDP. If I might just get up.

Senator Bennett. Yes. Let us be sure we understand this.

Dr. Hubbard. Basically saying in the first year, the calendar year we're in, we would expect an improvement in growth of this amount. We would expect a further improvement in growth next year. But of course, this part of the level goes up. So this is saying the level of GDP is higher in the first year. It's higher in the second year because this part accumulates plus additional growth.

Senator Bennett. No, I understand that. I understand that. The blue chip forecasts for next year are for 2.7 annualized rate in the first quarter, 3.2 in the second quarter, 3.8 in the third quarter, and – pardon me, 3.6 in the third quarter, and 3.8 in the fourth quarter, which would come in around 3 percent for the year.

Dr. Hubbard. Two things if I might about those forecasts. Of course that's a consensus that's part of a wide range.

Senator Bennett. I understand that.

Dr. Hubbard. Our own view is that's a bit a optimistic. And second, those forecasts build in already some assumptions about fiscal stimulus. They are making a guess as to –

Senator Bennett. Yes. I understand. But this is the numbers game that we get on television. I was briefly on television this morning, and they wanted a quick single answer, and I told them there is no quick single answer, which they take as a politician's answer.

But I'm trying to understand your chart here. And frankly, if I don't understand your chart, I think a lot of folks are not going to understand your chart. So what are you saying about 2003 with this chart with a hard number of 0.9 percent growth package effect?

Dr. Hubbard. Well, again, let's talk about the level of GDP. If GDP were $10 trillion for the U.S. economy, that would suggest an extra $90 billion in '03, an extra $170 billion in '04, an extra $180 billion in '05 and so on and so on.

Senator Bennett. Okay. I understand that. But can we put it into the number that always gets used to determine whether we're in a recession or not? The number that says that you either have positive growth or negative growth, and this year that number they're saying over the whole year, looking back, we had a positive growth of 2.75 percent.

Now on that number, what – you say the forecast numbers that I've given you are overly optimistic. Can you give us a number that you think will be accurate for 2003, with all of the caveats surrounding forecasts and the ability to change? We understand all of that. But if in fact the 3 percent plus number coming of this year's of 2.75 is a little optimistic in your view, do you have a number? Or is it a fool's errand to try to come up with a number? And if that's the case, I'll accept that as an answer too.

Dr. Hubbard. Well, we certainly have a number that will be presented Monday in the President's budget, so I don't want to get out ahead of that.

Senator Bennett. Okay.

Dr. Hubbard. But I think what the President was concerned about was not just the expectation, which is what blue chip consensus forecasts or our own forecasts or any other forecast is, but also the downside risks there. I think it's very unlikely that the U.S. economy will enter a recession, again, if by that you mean a couple of quarters of negative GDP growth, I think that's unlikely in almost any scenario.

Senator Bennett. Okay. All right. Well, let me go to one of the other things you said and then I'll move along, or allow the other Members of the Committee to move along.

But I think it's a very important point that needs to be emphasized over and over and over again that you touched on in passing, but I want to pull it out and highlight it. And that is the tax cuts, the reductions in marginal rates, do not go exclusively to wealthy individuals. We are not talking about Michael Jordan and Donald Trump and Ted Turner here.

For many of the tax returns that will fall into the top marginal rate, indeed for most of the tax returns that will fall into the top marginal rate, they will show K-1 income. Now I've asked the question around here ever since I got here as a Senator, does anybody know what a K-1 is? I won't ask for a show of hands, because it's always a little embarrassing because I've discovered that most of my colleagues have no idea what a K-1 is. They know what W-2 is, but they assume that all income that shows up on an individual's 1040 is W-2 income or investment income, and they don't know what a K-1 is.

So to explain to those out in television land who may not know, a K-1 is the tax form you fill out when you have a partnership, a small business,

or an S Corporation, where the earnings of the business entity, the company, pass through onto your personal tax form. I've had very direct experience with this.

Mr. Stark refers to my tax return. When we were running the company that I was the head of prior to coming to the Senate, we were an S Corporation, which meant that the earnings of the company passed through onto my personal tax return. Now these earnings were not exact, but let me use these numbers that will be illustrative.

I was being paid a salary as the CEO of that company of $120,000 a year. My tax return showed income of a million dollars. Where did the other $880,000 come from? It came from the company. Now I immediately had to give back to the company all of that money, except the amount of money they allowed me to keep to pay my taxes on that money. Actually, it was a detriment to me, because all of the deductions and exemptions that would be available to me at $120,000 immediately disappeared when the IRS saw that I was earning a million dollars a year. That was K-1 income, not W-2 income.

Now it just so happened that while I was running that company it was the decade of greed, at least as it was depicted by some people. The top marginal tax rate was 28 percent. That meant the earnings of the company that flowed through my tax return were taxed at 28 percent instead of 36 percent, or in today's atmosphere, after the Clinton tax increases of 1993, 42 percent. And I can tell you that the difference between paying taxes at a federal rate of 28 percent and paying taxes at the federal rate of 42 percent represented the difference between survival and failure for that company.

Again, it's not Michael Jordan or Ted Turner or Donald Trump. The majority of tax returns that show income in the top marginal rate are small businesses or partnerships that are passing through onto the individual return company income. So when you make the statement in your presentation that the acceleration of the reduction in the top marginal rate will significantly improve small business and create new jobs, you are exactly right.

I will agree that Michael Jordan doesn't need a tax cut. I will agree that Ted Turner doesn't need a tax cut. But small businesses whose owners are showing the income of the business on their individual tax returns significantly do need a tax cut, and it may be the difference, as I say, between survival and nonsurvival. As I say, we grew our company from four full-time employees, which is what it had when I joined them in the middle of decade of greed. That company was formed in 1984. Today there are over 4,000 employees, all of them paying income taxes. The growth of the company was financed entirely with internally generated money that we were able to hold onto with the difference between 42 percent, today's rate, and 28 percent, the rate during the Reagan years. It was not an insignificant matter, and it was not a matter of fairness. It was a matter of economic growth.

All right. I apologize. With that speech, I will yield now.

Dr. Hubbard. Could I actually comment, Senator?

Senator Bennett. Yes, you can respond.

Dr. Hubbard. I think you touched on two very important points, one on distribution even in the way that term is often used in Washington. The distribution table before and after the President's plan looks very similar. I.e., as you suggested, a lot of the benefits go to lower and moderate income families.

Your point on small business is incredibly on point. Because if you go to data say from the Survey of Consumer Finances, the Federal Reserve Board's data, about half of the households in the top 1 percent are almost exclusive small business owners, and people who are partial owners swell that number to closer to three-fourths of very high income taxpayers. So this is very much a business issue, and I thank you for making that point.

Senator Bennett. Mr. Stark?

Representative Stark. Thank you, Mr. Chairman. Thank you, Dr. Hubbard. Can you tell us or estimate for us on the same basis, particularly for next year, your estimate of how many new jobs the President's proposal will create. Do you have that information?

Dr. Hubbard. We've estimated for – just looking at the years you have here, for the 2003, a little over a half a million jobs, close to 900,000 jobs in the next year.

Representative Stark. So for a total of 1.4 million?

Dr. Hubbard. In the first two years, yes.

Representative Stark. Have you looked at either of the Democratic proposals, and can you estimate how many jobs you think that would create?

Dr. Hubbard. We've not estimated the number of jobs, Mr. Stark. I think it would be unlikely to be very stimulative, because these involve temporary tax changes, and our judgment would be there would be a very small effect on GDP and hence a very small effect on jobs.

Representative Stark. What do you estimate the effect on GDP would be for the Democrats' plan?

Dr. Hubbard. Well, a good rule – I don't know which of the many plans you're speaking of, but a good rule of thumb would be that temporary tax changes would have only a third to a half the spending effect of a permanent tax change, so you could scale it from there.

Representative Stark. You say it would only be a third of what you have on the chart. It would be about three-tenths of a percent in 2003?

Dr. Hubbard. Well, again, I'm not sure what plan you're referring to. But for a given size tax cut, the temporary tax change would only be a third to a half as effective.

Representative Stark. I guess there's some significant differences. I think most people would agree what's wrong with the economy and what the risks are. We don't have enough business investment. Businesses lack confidence, or certainty, or both. The consumer has been carrying the load. And a lot of that has been in the real estate market, which I'd like to come back to in a minute if I can.

When economic conditions are so uncertain and the job market is so weak, we don't know how long we can keep going. The only good news as you showed us earlier is that productivity has been holding up. And

you suggest that our long-term prospects are good even without the President's proposed tax cuts. So the problem seems to be mainly short-term, if we accept your scenario.

So why aren't policies aimed at maintaining consumption and helping out strapped state and local governments, exactly the right policy? The long-range economic growth predictions look fine. Why would large tax cuts that go to high income taxpayers, likely to save the economy more tax cuts targeted on middle and lower income taxpayers who are ready to spend those monies. We'll create jobs right away and we'll have more spending? What am I missing something here.

Dr. Hubbard. Well, I think what the President is trying to do, Mr. Stark, is to connect the tax relief to what we believe the problem to be, which is shoring up the consumer and investment, as you just correctly noted. Temporary tax changes have a small effect. If your goal is to shore up consumption, you've picked the wrong thing to do it. You might as well save your bullets if that's your answer.

As for spending projects, say public works projects, we know that Japan tried over a decade a series of fiscal stimuli on spending that fails to improve an economy's capacity to grow. You correctly identify of course that states have significant fiscal crises. Many of those are structural problems that aren't well addressed by one-time effects.

What the Federal Government can best do for states is to improve the environment for growth. We've looked state-by-state at the response of state income to changes in overall income and state revenue in response to changes in overall income, and believe states could gain from that as much as $6 billion. I realize that is much less than the shortfall, but we believe that is the appropriate role for the Federal Government.

Representative Stark. Let me ask you this. Mr. Zandi of economy.com says that the Democratic proposal would add 600,000 more jobs than the President's plan. I presume you disagree with that?

Dr. Hubbard. Well, again, I'm not sure what you mean by the Democrats' plan. If you mean the temporary tax changes that have been talked about, I think that would just be fanciful –

Representative Stark. Let's say putting $150 billion rather than $35 or $50 billion up front in the –

Dr. Hubbard. It depends very much, Mr. Stark, on how you use the $150 billion. Temporary tax changes have fairly modest effects. The President again has a calendar year liability change of $100 billion. The plans originally I guess that Congresswoman Pelosi had floated would have had very similar cash out the door in 2003 compared to what the President had, but again, being temporary, would have had a very small effect.

Representative Stark. Let's go to the real estate issue for a moment. You managed to suggest years ago that increasing the deficit would also increase interest rates. They're suggesting perhaps that that doesn't hold anymore, so it depends on whether I'm talking to the professor or the head of the economic advisers as to who you believe.

But let's assume for a moment that interest rates increase. Wouldn't that have a very serious effect primarily on the housing market, the

single-family housing market, which seems to -- the bubble there seems to be expanding and not bursting? Perhaps not. Perhaps you can explain why that's growing, Wal-Mart isn't and Caldwell Banker is. I gather we're having more housing starts. And I'm happy, but I'm nervous. In other words, if you have unemployment and if that spreads or it doesn't increase, and interest rates go up, eventually you won't be able to sell that house if you move. I see a danger there. Tell me it isn't there and you'll make me very happy. But perhaps you can shed some light on that.

Dr. Hubbard. I think you have correctly identified the importance of housing and housing wealth for consumers. And I think current housing prices do reflect fundamentals in large part. One, as you just noted, we have the lowest interest rates in a generation, so the user cost, if you will, of owning a home is very low. And a variety of demographic considerations have put wind in the sails of the housing market, all true.

Changes in the stock of government debt do of course affect interest rates, but very, very modestly. In this year's economic report of the President, we'll talk about model-based calculations based on work widely accepted in the economics profession, a change in the stock of government debt on the order of $200 billion might affect yields by 3 to 5 basis points.

Now if you ask yourself why aren't the effects larger, look at your intuition from current events. We have seen very large changes in projected fiscal situations and very low interest rates. I'm just telling you many, many, many factors determine interest rates.

Representative Stark. Thank you.

Senator Bennett. Thank you very much. Now with the Chairman and the Ranking Member having gone on at length, we will enforce the five-minute rule, but we will have as many rounds as any Member wants to have. Mr. Saxton?

Representative Saxton. Thank you very much, Mr. Chairman. And Chairman Hubbard, I would like to use my five minutes to try to make a point that often comes up in discussions about various tax cut proposals.

Whenever we are on the floor in a debate, there are those who will contend that reducing marginal tax rates and reducing other tax rates, for example the double taxation of dividends, may bring about a big number and it becomes a concern of a lot of folks, in terms of its effect on the deficit or on the potential deficit.

Now just by way of explanation for people who may be in the room or elsewhere listening, the process of determining what a tax cut will do depends in part at least on explanations by two organizations. In particular the Congressional Budget Office (CBO) makes projections about what's going to happen in terms of surplus or deficit as we move forward in 2003 and 2004. And a separate organization known as the Joint Tax Committee, scores the tax bill and determines how much it will reduce potentially federal revenues over the same periods of time.

And the argument is often made that tax proposals like the one which we are focusing on this morning cause deficits to rise, or surpluses to go away. And I brought a chart with me, if we could put it up, which demonstrates I think quite well the results of the projections of CBO as

compared to the projections of the Joint Tax Committee. In the top block – this is going back to 2001 when the initial Bush tax cuts were put in place. These were the projections that were made. In the top line, the total surplus at the time that was projected for 2002 was $313 billion. That was the projection of CBO.

The Joint Tax Committee scored the cost of the tax bill that year in static numbers at $38 billion, leaving a projected surplus of $275 billion. Now we all know that as we began to see these numbers actually play out, that the surpluses were actually less than the CBO projections. Could you explain for us these numbers and the actual revenue effect of the tax cuts as they appear on this chart?

Dr. Hubbard. Certainly, Mr. Saxton. I think you put your finger on a very important point of information for all Members of Congress as they debate tax legislation, and that's what do you think the effect is. If you're a businessperson, and I went to the Capital Budgeting Committee and I had an elaborate presentation of how much a plant would cost, but then I didn't tell you how much I expected to make from it, it would be very hard to get you to agree to that capital budgeting decision. And yet, I think we sometimes don't provide you the information you deserve on what the economic effects are of tax policy.

In the context of revenue, those can be large, and they depend a great deal on the kind of a tax cut. We have estimated, depending on assumptions and model you use, that over the budget period that's coming out, over the five-year period, between a third and a half of what we'll report is the cost of the tax proposals from the President would come back to the government through higher economic growth and hence higher federal revenue.

In the long term, I showed the chart earlier, there's a permanently higher level of GDP and higher federal revenue.

For many years as an academic and in the government, I have suggested that you would be better served by getting in addition to scoring an impact statement that told you based on a range of models what is likely to happen to the economy in federal revenue.

Representative Saxton. Thank you. So the numbers that we see here on the chart, particularly the static cost of the tax cuts, you would say are not responsible for the deficit situation that we find ourselves in today?

Dr. Hubbard. Well, they're certainly not, the deficits that we have seen just here in the current period are largely driven by the weak economy and the necessary spending on homeland security.

Over the long haul, it's our economy's ability to grow that affects all of us, not just our budgets as families and businesses, but the Federal Government as well.

Representative Saxton. Well, thank you, Dr. Hubbard. I think this is an extremely important point. And as we examine the proposals laid out by the President and the Administration and we look at the cost figures, we should keep in mind that the costs, the actual static costs of the proposed tax cuts are not deficit drivers, they are in fact a very small portion of what we look at today and the projections in terms of the

deficits that may come, or the surpluses if we're more optimistic. Certainly, if the President's plan performs as we think it will, we'll be talking surpluses again, not deficits.

Senator Bennett. Thank you. Mr. Ryan?

Representative Ryan. Thank you, Mr. Chairman. Chairman Hubbard, I wanted to explore with you some questions about the dividend policy in particular and the difference between corporate and the individual side.

I introduced a bill which repealed dividend taxation at the firm level, at the corporate level, and then brought the individual tax down to the capital gains tax rate. And from my preliminary discussions with the score keepers at Joint Tax who are basing it on static, non-reality-based scoring, the number is looking like it's going to be a huge score relative to what the individual score that you've proposed.

Can you walk me through why you think it's superior to eliminate the double taxation of dividends on the individual side versus the corporate side? And also one of the other large problems with the double taxation of capital occurs is on capital gains tax treatment. And when you repeal it at the corporate side, you don't get at the capital gains issue.

Can you explain how you get at the capital gains issue when you step up the basis on the individual side? So from my perspective, it sounds like from now looking at your proposal, you're getting more bang for your buck. You're using less revenue and you're getting sort of two tax cuts in one: A reduction in capital gains and an elimination of the tax on dividends. Can you just explain how exactly that works?

Dr. Hubbard. Sure. Let me start just with the budget question you asked. One reason the relief at the corporate level will be much more costly is many dividends go to exempt entities, either tax-exempt formally or through tax planning or foreign investors receiving a break. That was one of the reasons the President selected the individual side.

You've heard the President speak of taxing corporate income, all income, once. But he means once, not zero. And so if one had it at the corporate level, much of the income might not be taxed at all, and that's why there's a big difference.

As you indicated, doing so on the individual side offers very important opportunities in the capital gains area as well. Just as we now have a tax code that's biased against dividends, we don't want it then switched to a tax code biased entirely for dividends. Business people have many sound reasons for retaining earnings, so we wanted neutrality.

The step-up in basis that you mentioned is equivalent to saying any earnings you accumulate in the company, in the President's plan going forward, would not be subject to the capital gains tax because if you'd paid them out as a dividend, they wouldn't have been subject to the dividend side.

Representative Ryan. Any of them you pay tax on, correct?

Dr. Hubbard. That's correct. So it is a very large bang for the buck, because you're focusing on the so-called marginal investors, the taxable investors, and you are getting very large relief on the capital gains side as well. So we think in terms of economic efficiency, this is the way to go.

Although from an economist's perspective, again, getting rid of the double tax is the key.

Representative Ryan. Do you think that the macroeconomic feedback that you discussed with Mr. Saxton that is derived from the individual side policy is better the way you structured it than doing at the corporate side?

Dr. Hubbard. I think the bang for the buck frankly would be greater, because then the revenue costs are –

Representative Ryan. Because of the step-up in basis.

Dr. Hubbard. Right. And the inclusion of step-up basis.

Representative Ryan. Could you also inform us on how this improves corporate governance and how this helps stem tax sheltering? I saw Mr. Sarbanes here a minute ago, the prime author of a very important law to improve corporate governing, and one of the things that we noticed in the last collapse of a lot of prominent corporations was they weighed themselves so heavily with debt and they went into bankruptcy. Tax law incentivizes companies to take on more debt because interest is deductible, but not to grow their companies through equity financing, because it's not as tax advantage – it's not as advantageous from a taxing perspective.

Can you go into how this improves from a neutrality point of view corporate governance?

Dr. Hubbard. Happily. I think as you mention, the Sarbanes-Oxley legislation is truly landmark and very important, because it gets at accountability and transparency issues. But I think it's also important, as your question suggests, to ask what were the incentives for some of these transactions to begin with?

The Tax Code, by treating the timing of income and different types of income differently, creates enormous opportunities for tax planning. Many companies engage in very complex tax planning techniques. They are not illegal techniques, but they are techniques that make it very untransparent what the earnings situation of a company are. By taking away the bias between debt and equity and getting at the capital gains piece from the basis adjustment, a lot of the wind in the sails of the tax planning is gone. So the tax shelters have much less need.

So in addition to the standard economic arguments, I think these transparency arguments will be very valuable for investors.

Representative Ryan. Am I out?

Senator Bennett. You are out.

Representative Ryan. Okay. Thank you.

Senator Bennett. We'll have another round. Senator Collins, we welcome you to the Committee here this morning. We appreciate you being here.

Senator Collins. Thank you very much, Mr. Chairman. Dr. Hubbard, I'd like to turn your attention for a moment to the impact of the President's proposal on state tax revenues. As I'm sure you're well aware, more than 40 states are facing severe budget shortfalls and are struggling with how to close those deficits, because unlike the Federal Government, they have to balance their budgets.

Like many states, my home State of Maine conforms its tax code to take into account changes in the federal tax laws, and this is done automatically. That obviously simplifies life for Maine taxpayers, but it has an impact when the Federal Government changes the tax code on the amount of revenues that the state of Maine collects.

According to preliminary estimates by the State of Maine, the President's proposal has both good and bad news for the people of Maine. The very good news is that the proposal would save Maine taxpayers more than $350 million. The bad news is that the state, which is already struggling to close an enormous budget shortfall, would lose $40 million in tax revenues as a result of the President's proposal.

Could you comment on this issue which is troubling to many of the states, particularly since the President decided not to include fiscal relief to the states as part of his package which might have helped to offset this impact?

Dr. Hubbard. Certainly, Senator. There are really two channels through which what the President is proposing might affect state finances. One, as you mentioned, is the fact that dividends would be taken out of the base for the 1040 and hence affecting states' piggybacking. Another would be effects people have hypothesized for the municipal bond market, changing the borrowing cost for states.

Let me go through each of those. It is true that taking dividends out of the base would affect states if they chose not to reintroduce. Nationwide, that's probably about $4 billion, the states. We have estimated that effects on municipal bond yields using studies done at the Treasury a decade or so ago and academic work are no more than 10 to 15 basis point effects on municipal bond yields. And the net effect of both of those we believe is overwhelmed by effects on economic growth.

We expect that states as a whole will gain as much as $6 billion in the first year from the President's plan, higher economic growth producing higher revenues. Most states have slightly more than a one-for-one response. I'd be happy to take a look at Maine if you like. The way you asked the question made me think also that Maine may be okay in the sense that the higher gains you mentioned may also feed through additional revenue from job creation and economic growth. But I would be happy to work with you on that.

Senator Collins. I would appreciate that. Thank you, Mr. Chairman.

Senator Bennett. Thank you. Dr. Hubbard, following up on Mr. Stark's comments and the exchange there, I'd like to go back and talk some more about job creation. And again, as I jotted it down, you're projecting in the next two years, again with all of the caveats that go around forecasts, 1.4 million jobs being created as a result of the President's proposal, and that the Democratic proposal would produce roughly a third of that number.

Dr. Hubbard. Well, again, I haven't analyzed the Democratic proposal. The third was just a reference to the fact that GDP changes are much less from those sorts of proposals.

Senator Bennett. Okay. Forgetting the specific numbers, where I want to go is why is there a difference? And I think I heard you say the

difference is because the President's proposal is permanent and the Democratic proposal would be temporary. And a temporary placement of money into people's hands through a rebate or something of that kind has relatively small effect, and a permanent change makes it possible for business people to plan and make investments that will create jobs and therefore be far more beneficial in the long run.

Have I got it right, or did I miss something?

Dr. Hubbard. Yes, Senator. There are really two channels. One you mentioned, permanent, long-term tax cuts have much larger effect on consumer and business decisions. Second, the President's plan is actually aimed at investment through the rate cuts, through the expensing, through the elimination of the double tax. The Democratic plans would seem to be only loosely connected to that problem.

Senator Bennett. Let me change subjects then for just a moment and ask you something unrelated to your opening statement but that I think we have to deal with following the President's State of the Union message. A number of economists have said that the stock market and indeed the economy as a whole is currently burdened by geopolitical risks and that concern over Iraq is holding down investment and that we will not see the kinds of economic growth that you're projecting until the geopolitical uncertainty is resolved, one way or the other.

There are others who say, no, the market has already absorbed that kind of risk, and the present softness is not due to fear, or uncertainty relating to the geopolitical circumstance. Once the Iraq situation is resolved one way or the other, the softness that is currently there will continue.

I know you're not in the war forecasting business, but nonetheless, an economist has to take into consideration all of the uncertainties that relate to the economy, and certainly geopolitical risk is a major factor here. Do you have any sense of whether or not the market has absorbed the risk and therefore we would have a continuation of the soft patch once the Iraq situation is resolved? Or have you any view that resolution of Iraq would in fact remove one of the major wet blankets on the economy and we would see a significant increase? Just your comments about that whole circumstance.

Dr. Hubbard. Sure. In terms of thinking about uncertainty that business people talk about, obviously geopolitical risks figure prominently in that risk. But business people often talk about uncertainty over the economic recovery itself, which has a kind of chicken-and-egg character to it, again because their own decisions influence.

When you think about geopolitical risk, I guess it's compared to what. There are certainly geopolitical risks in the present environment. We all know events in the world. But let's remind ourselves of the terrorist risk and threat that the President is trying to address for our national security also has effects on our economic security as well.

I think what the President was trying to do in his proposals, his tax proposals as opposed to national security policy, is to make sure that we do what we can to lower the hurdle rate for investment.

Senator Bennett. I have had some very prominent economists say as soon as Iraq is resolved, the economy will take off like a rocket, whether it's resolved with a military victory or Saddam Hussein going into exile or whatever. But that right now, everybody's sitting on the sidelines. And I take it from your answer you're not prepared to put yourself firmly in that camp?

Dr. Hubbard. Again, I think that is among the sources of uncertainty, but I think there are many sources of uncertainty weighing on business people's minds.

Senator Bennett. Okay. Thank you. We'll go on in the next round. Mr. Stark?

Representative Stark. Dr. Hubbard, in the last recession, the temporary federal unemployment program (UI) lasted for 30 months. And the unemployed received 26 weeks of benefits, 33 weeks in the high unemployment states. That number prevailed for two years after the recession began and all during the time the state UI exhaustions were increasing. We don't reach a comparable point in this recession until March of this year. Your own Department of Labor agrees that we've got about one million workers who have exhausted all of their federal and state UI benefits and they're looking for work, trying to find work.

Most of those million workers only receive 13 weeks of benefits, about half of what workers received at a comparable point in the last recession. Is the Administration able to explain why we shouldn't spend $3 or $4 billion out of the $600 billion to assist these workers who are basically bearing the real pain of this recession when we propose this huge tax package? Why can't we find $3 or $4 billion out of that to help the unemployed – almost all of the $600 billion goes to the wealthy. Why can't we find $3 or $4 billion to expand the 13 weeks? Senators Durbin and Reed have an amendment that they say would have cost about $6 billion because it covered a few more than just the million workers.

This money would get spent obviously immediately, so there's no question it would be an immediate stimulus. Why is the Administration avoiding doing what we've done in the past?

Dr. Hubbard. Well, I can't resist at least commenting on the notion that $600 billion for the wealthy is grossly inaccurate. As I suggested before, distribution tables are the same pre- and post, and again, I dispute who bears the burden of taxes in your statement.

But to your question, I think this is very much on the President's mind. And in fact, I think his plan both in pro-growth policies and in reemployment accounts is that we focus on getting people back to work and not on unemployment insurance. You picked a number of $3 to $4 billion. That's a very convenient number, because it happens to exactly be the amount the President proposed for personal reemployment accounts precisely aimed at the population of people likely to exhaust UI.

Our philosophy is that what is important is to get people on the right kind of training programs to get them back to work. And the purpose of the reemployment accounts is to give individuals control over training for income support and so on to get themselves back to work. Extending

unemployment insurance creates more unemployment. Getting back to work is what the President has in mind.

Representative Stark. I beg to differ. I mean, my God, $3 to $4 billion to create a program that doesn't exist would take a year, year and a half. You haven't even gotten the homeland security building location picked out yet, much less spent. Unemployment insurance would happen tomorrow. These are people who were working. They had jobs, and the jobs disappeared. They've got the training. They could go back if the jobs were there.

The humane thing is to give these people the money so they can pay their mortgage and pay off their credit card, pay their rent, feed their kids. They were designed to help people who are down on their luck, who had been working, hard working Americans, working, paying their taxes, obeying the law. They weren't in jail. They're not welfare people. They are people who through basically no fault of their own, a million of them, are out of work. And in the past, past Republican Administrations, thank you very much, have seen fit to pay them out. And this is a paltry sum out of however much you're talking about spending and where you think it goes, at least half of that $600 billion goes to people in the upper 1 percent. You can't deny that. What happens to the other half we won't argue about.

But $3 or $4 billion gives people the dignity at least of not having to beg, not having to go on public assistance. And the states can't afford it. We know that. We just heard from Senator Collins that you're not helping the states with their Medicaid, which is increasing. It's a small amount. It's a humane thing to do. If you're right, and I hope you are, then why wouldn't you want to let these people have an additional 20 weeks, less than half a year, of knowing that they're going to be able to feed their families, pay the rent and in a cold spell like this, heat their houses?

Dr. Hubbard. Two points. Again, I think what the Federal Government can best do for everybody, employed and unemployed, is to promote economic growth and the ability to get back to work and the dignity of a paycheck.

I would dispute the notion the personal reemployment accounts are a long way away. States already use right now this day the same kind of scoring that are necessary to implement personal reemployment accounts, and the funds will be distributed as a block grant. So I think this is something that provides immediate relief, and almost more to the point, is a very, very important change in the way we view the government's role; that is, promoting work, not unemployment insurance.

Representative Stark. Are we going to have another extension when this one runs out?

Dr. Hubbard. That's a subject that has to be worked out with the Congress.

Representative Stark. What's the Administration policy?

Dr. Hubbard. The Administration looks forward to working with the Congress on the unemployment insurance question. The President

believes that the best way to get to the problems you correctly identified, Mr. Stark, are through personal reemployment accounts.

Representative Stark. How soon will these accounts be available? Next week?

Dr. Hubbard. That's of course in large part up to you, Mr. Stark, and your colleagues. The sooner the better.

Representative Stark. But the unemployment benefits are up to you. They could be available next week, couldn't they?

Dr. Hubbard. Again, the Administration looks forward to working with the Congress –

Representative Stark. Just technically, they could be available instantly and the training programs would have to be put in place. I'm just suggesting, I mean, how about ten weeks? I'll split the difference with you.

Dr. Hubbard. The training programs require –

Representative Stark. It's cold.

Dr. Hubbard. – very little time, Mr. Stark. What's at issue is giving individuals the power to select from training programs that are already there.

Representative Stark. I'm sorry, Mr. Chairman. We're talking about two different things here. The price of heating oil is a buck eighty and it's cold outside. And if you're unemployed, training isn't going to get you warm.

Senator Bennett. Mr. Ryan?

Representative Ryan. Thank you, Mr. Chairman. I'd like to go back to dividends if I might, because Mr. Stark and I serve on the House Ways and Means Committee, which is in charge of this bill. Can you help me understand how implementation of a dividend works from the corporate perspective on informing the taxpayer on the basis and the dividend? How does it actually occur where the corporation communicates to the person so they can prepare their tax returns appropriately and for the step-up in basis?

Dr. Hubbard. Sure. Let's first think at the corporate level, our top tax lawyer at the Treasury estimates that in her distinguished private practice, she would only be able to squeeze a few billable hours out even for a large company to set it up. For the investor's perspective, there's really two boxes that would be added to the 1099, the form that you currently get to tell you about dividends. And basically one would be the dividends that are excludable or not, and second, what your basis adjustment is.

If you own mutual funds, the record keeping for that is done by the mutual fund –

Representative Ryan. Mutual fund sends you the –

Dr. Hubbard. For individuals who own a lot of individual stocks, most of whom would be more well-to-do, they would simply keep track of the pieces of paper. You can in no way be worse off than current law. If you don't want to keep track of paper, you can pay the capital gains tax, but I think it's a pretty modest record keeping for most individuals.

Representative Ryan. One of the other issues that we're going to have to deal with in Committee is our whole ETI foreign sales corporation problems on the international tax side of the code. Can you help me understand the interplay with this dividend proposal with respect to companies who get foreign source income, how it works with the anti-deferral rules and the tax credits, how they report it back, how they report the step-up in basis? Isn't it a little more difficult to do for companies that earn foreign sources income? Can you explain that.

Dr. Hubbard. Well, first of all, all companies, multinationals and not, benefit from the lower cost of capital. The foreign tax credits abroad for foreign taxes paid are flowed through, because we're trying to eliminate double taxation. For companies who are foreign operating in the United States can still pass through income they've earned in the United States.

As you know as well as I, the foreign area of the Internal Revenue Code is very difficult, but we don't see this as adding to the complexity.

Representative Ryan. Okay. Let me go at it another way. We really do still double tax companies on foreign source income. The tax credit does not adequately protect against paying two taxes, a foreign government's tax and the U.S. government's tax. That's something we're going to have to clean up. We're going to have to move bills to do that. We're going to have to do it so it's WTO compliant, because we've lost four of these rounds.

So in the absence of having a clean tax credit regime to prevent companies from being double taxed from a country perspective, aren't we going to have some problems keeping records on that kind of income where we send dividends from overseas back to the United States and where we send a step-in basis from overseas back to the United States? Do you foresee any more higher degree of complication?

Dr. Hubbard. You needn't, Mr. Ryan, depending on how you approach the ETI fix, it's quite possible to clean up interest allocation rules, to clean up the way we tax active income abroad, that would go hand-in-glove with what the President's proposing.

Representative Ryan. That's what I'm trying to get at. I think we're going to hopefully fix the interest allocation rules, the base sales and services, shrink the baskets from nine to three or something like that. Does this jibe well with those plans?

Dr. Hubbard. It does indeed. In fact, there is a January 1993 Treasury pamphlet that describes how to make the foreign tax system more consistent with exactly this kind of a proposal.

Representative Ryan. Those are the questions I think you're going to get some more of when you come over to the House side, so I think that that's important to focus on that. Thank you.

Senator Bennett. Thank you very much, Mr. Ryan. As we sum up here, Dr. Hubbard, I am struck, as a number of people are, with the changed economic atmosphere in which we live. I say to people, this is the first recession of the Information Age, not the last recession of the Industrial Age.

I think the recession that we had in the early '90s was the last recession of the Industrial Age. And now that we live in the Information Age where data are available to managers in real time instead of delayed, decisions can be made virtually by the hour. You see something showing up on the sales floor, you can change your inventory immediately with a computer. You can get a hot item into the customer's hands by tomorrow morning. Very, very different from the traditional inventory recession where you get a build-up of cars in the back lot and then suddenly discover that they're not selling and you have to shut down the plant till all of the cars move out, and that's going to take you six months.

That's the old model that I learned about in school of the Industrial Age recession, and it simply doesn't apply anymore. And I think your chart showing the difference between the pattern of this recession and recovery compared to the average validates that view. So if this is indeed the first recession and the first recovery of the Information Age, we are plowing new ground, and we're trying to learn new things. And that adds in a way to our uncertainty.

With that background, this is my question. There is worldwide overcapacity in a number of basic industries. Steel is the poster child for worldwide overcapacity. As we work our way through that, do we have a problem with respect to stimulating investment if the impact of the stimulation of investment is going to add to an existing circumstance of overcapacity? And globalization means that steel capacity in Singapore impacts steel capacity here.

In microchips there is a cutthroat, vicious kind of competition around the world, with other countries subsidizing through government for extended periods of time – beyond what we would ever have thought they could sustain – investment in still increased capacity in microchips. I'm particularly interested in that because Micron has built a plant, put more than a billion dollars of investment into my home State of Utah for the privilege of producing chips at a loss because of where the world market is going.

Step back from the partisan kind of questioning that sometimes goes on up here where some people are throwing spears at you and other people are throwing softballs at you, and address this question long term from your perspective as a thoughtful economist, what you think is going to happen in terms of the new age in which we now live, a global economy, an economy without borders, information that makes it possible for people to make more intelligent kinds of investments but the desire to seize the market by overinvesting perhaps and then driving your other competitors out of business, this is a world very different from the one that was outlined in the economic classes that I took in the 1950s.

Can you share with us your view of the impact of overcapacity on the kind of recovery we're looking at and then the world as a whole in the brand new world we've entered?

Dr. Hubbard. Sure. We're of course working through, and in my view have largely worked through overcapacity from excess investment in the late 1990s. As for steel, it's important to note that a lot of steel investment around the world was uneconomic on private economic

grounds. Government subsidies in a variety of ways kept steel capacity too high, and this is one of the things that is going on, as you know, Senator, in the OECD discussions on how to rationalize capacity in the steel industry. And our government has played a big role in that.

At the Council, we've tried to estimate what we think excess capacity is, and we believe that outside of the telecommunications sector where that is truly still a major problem, excess capacity is relatively modest and suggests that a stimuli to investment can really boost investment and capital formation.

Your point about globalization I agree with 100 percent. And to me as an economist, what it suggests is the need to make sure the nation has the most competitive policies possible, to make sure that we have a tax policy that is very much centered on the age that you described. Mr. Ryan had inquired about the way we treat multinational companies. That is clearly part of it. The way we treat investment in the United States. These are issues that will become more and more on your agenda in this new age.

Senator Bennett. So I repeat a question that came up earlier. Do other countries with whose industries we compete with tax dividends twice?

Dr. Hubbard. Almost all of the G7 has some sort of integration relief, not all as much as the President has suggested, but we are the double tax bad boys in the G7.

Senator Bennett. So this question is not only a fairness question, a corporate governance question, it is also a competitive question as far as the rest of the world is concerned?

Dr. Hubbard. It's very much a competitive question not only for companies operating here at home, but for companies operating around the world.

Senator Bennett. And again, coming back to what I think I heard you say, but want to be sure, the major difference in the long-term growth impact of tax reform is whether or not it's permanent or temporary? That a temporary tax fix comes and goes as a quick spike and has no long-term effect, but a permanent change of the kind the President has talked about builds in long-term productivity. Do I have that right?

Dr. Hubbard. You're exactly right, Senator. The long-term tax changes are better. They help stimulate spending. They give households and businesses a longer horizon to plan. In addition, of course, what the President has done is proposed a fairly dramatic tax cut on the cost of capital for investment.

Senator Bennett. Thank you very much for your testimony. We appreciate again your service.

Dr. Hubbard. Thank you, Senator.

Senator Bennett. I go back to when I was first in this town as a young staffer and remember the fight led by John F. Kennedy when he wanted to reduce the top marginal tax rate from 90 percent to 70 percent, and everyone said it was going to blow a huge hole in the budget and that it wasn't fair. Does that sound somewhat familiar in today's circumstances?

Dr. Hubbard. We've been there once a decade, Mr. Chairman.

Senator Bennett. And the phrase that was used then echoes I think with your testimony. JFK said, "A rising tide lifts all boats". And the people at the bottom will be benefitted as the economy works out, the growth in the economy works out as a result of this.

It's very interesting that there were those who resisted the top marginal tax rate at 70 percent on the ground that we couldn't afford it long-term in deficit. I don't think anybody would today say in order to be fair, we've got to go back to a 70 percent marginal tax rate. At least we've made some progress in that we're trying to fight between a 42 percent, which is the effective rate today when you add the Medicare on top of the tax, income tax. The President is trying to get it down below 40 percent. I'd love to see it below 30 percent and so would the majority of the American people if we pay attention to the recent polls.

With that, again, thank you for coming. This hearing is adjourned.

[Whereupon, at 11:42 a.m. on Thursday, January 30, 2003, the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Good Morning and welcome to the first hearing of the Joint Economic Committee (JEC) in the 108th Congress. I am happy to have the privilege of chairing the Committee for the next two years, and would like to begin by thanking Representative Saxton for the fine work he did as chair during the previous Congress. I hope that the JEC is able to accomplish as much this term as it did under his able hands during the previous Congress. I also wish to welcome our Democratic JEC members to our hearing today; I look forward to continuing the Committee's tradition of working together with the utmost in courtesy and civility.

Today, I am pleased to have as our distinguished guest Dr. Glenn Hubbard from the Council of Economic Advisers(CEA). Dr. Hubbard has served the President ably over the past two years, and I hope that your return to academia is refreshing, productive, and brief, for we have all benefitted from your wise council over the past two years. It is fitting that we have the head of the CEA here with us today; the JEC and CEA were created together in 1946 and have worked hand-in-hand over the years to provide timely and objective analysis of public policy for our respective branches of government. My staff and I have enjoyed working with the CEA and I expect this cooperation to continue.

The economy currently appears to be going through what Fed Chairman Alan Greenspan called at a recent JEC hearing a "soft patch", and the lack of robust, sustained economic growth has been a frustration to all of us. The proper role of government in alleviating a sluggish economy and accelerating the nascent recovery is a difficult one, and one with as many different answers as there are economists.

The primary focus of today's hearing is the Administration's attempt to counteract the recent pause in robust growth as well as ensure future economic growth with its recently proposed economic growth package. The proposal involves accelerating tax cuts already scheduled in 2004 and 2006 so as to take affect in the current year, increasing the expensing of investment for small firms, eliminating the marriage penalty, increasing the child tax credits, and providing states with funds to establish individual re-employment accounts.

The tax cut proposal is a bold one, and one that is sure to increase the budget deficit in the short run. However, I do not necessarily believe that the primary factor in judging a policy ought to be its impact on the near-term deficit. I think one lesson we have learned over the past thirty years, through both Republican and Democrat administrations, and Democratic and Republican Congresses, is that solid economic growth can be a wonderful elixir for an economy. I am very much interested in how Dr. Hubbard and his staff believe the President's proposal will increase economic growth in both the short run and the long run.

The most ambitious part of the stimulus growth package is undoubtedly the removal of the double taxation of dividends, and I am

sure that most of the questions today will be about the particulars of this plan. There are many different ways to structure tax reform so as to eliminate the double taxation of dividends, a pernicious distortion of the tax code that has been almost entirely done away with in developed economies. I welcome the opportunity to have Dr. Hubbard explain some of the details of the tax cut and the choices made in constructing the plan.

I also welcome Dr. Hubbard's thoughts on the current state of the economy. The recent release of the fourth quarter GDP numbers seem to indicate that the current soft patch is still with us. While the growth numbers were disappointing to all of us, the data I have examined suggests to me, at least, that we should expect more rapid growth in the upcoming year.

Again, we welcome you to the JEC, Dr. Hubbard, and look forward to your testimony.

PREPARED STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Thank you, Chairman Bennett. I want to congratulate you as the new Chairman of the Joint Economic Committee. I also want to congratulate you for holding thishearing. All indications are that Dr. Hubbard was an important architect of the Administration's latest economic plan, and I welcome this opportunity to hear how he responds to some fundamental concerns that I and many others have about that plan.

I hope we can all agree that almost two years after the start of the recession in March 2001, the economy is still in a slump and is not creating jobs. GDP growth in2002 was too weak to bring down the unemployment rate, which stands at an eight year high of 6 percent. On net, no new jobs were created last year. In fact, payroll employment ended the year slightly below the already depressed level reached at the end of 2001.

The economic outlook can be summed up in the title of the old Buddy Holly song, "Crying, Waiting, Hoping." We're crying because the economy is not delivering the jobs it should; we're waiting for businesses to start investing and rehiring again, because new business investment is critical for mounting a sustainable recovery; and we're hoping that the battered and anxious consumer will keep spending in the meantime, so that the economy does not slip back into recession.

I wish I could say that the President has a plan that would address the real problems in the economy, but he does not. Instead of a plan that would put money into the hands of those who need it and would spend it immediately, the President has proposed to eliminate the individual income tax on dividends paid by corporations and to speed up the rate cuts that go to a relatively small number of high-income taxpayers. There are other things in the President's plan, but those two proposals account for more than half of the cost. I see three major problems with the President's plan.

First, it does not provide job-creating stimulus when we need it. The impact in this fiscal year is a paltry $35 billion or so in a package that costs a whopping $674 billion over the next 10 years. We need to do more now to create jobs and put people back to work. The Administration's program relies almost exclusively on tax cuts and ignores government spending, which can have a direct and immediate impact on jobs and incomes.

For example, the President's program provides no relief for the states, whose financial crisis will force them to raise taxes or cut spending at exactly the wrong time in the business cycle. States will have to lay off workers and there will be no money for child care and other support services that help single working mothers. Moreover, the Administration's dividend proposal would automatically reduce the tax base of states that tie their income tax to the federal form. The President's plan does not directly address the problems facing people who have exhausted their unemployment benefits but are still having trouble finding a job. A true job-creating stimulus package would pack more punch in the first year. For example, the proposals of House Democratic Leader Pelosi

and Senate Democratic Leader Daschle would each provide about $140 billion of immediate stimulus to put people back to work as quickly as possible.

A second problem with the President's plan is that it is fiscally irresponsible. It either drains budget resources that could be put to better use—such as really improving Medicare—or it increases the deficit. In the latter case, once interest costs are taken
into account, the President's new tax cuts would add almost a trillion dollars to the national debt over the next 10 years.

You would think that with the retirement of the baby boom generation just a few years away, we would be taking steps to make sure that we have the budget resources to honor our Social Security and Medicare commitments. Instead we are squandering them on tax cuts that are hard to justify. I think you would be hard pressed to find many economists who think that the major reason unemployment remained stubbornly high last year was the double-taxation of some dividends. But I think you could find a lot who believe that large increases in the public debt are bad for interest rates, investment, and long-term growth.

So, why is the Administration proposing something that doesn't help in the short-term but undermines budget discipline in the long run? Once again, it is instructive to compare the President's proposal with the Democratic alternatives, which concentrate almost all their impact in the first year, without worsening the deficit in subsequent years.

My final problem with the President's plan is that it is unfair. People with incomes over a million dollars get tax cuts of almost $90,000, much of it from the dividend proposal and the upper bracket rate cuts. The average family receives almost no benefit from those provisions. The Administration cites new data from the Federal Reserve showing that more than half of American families own stock, either directly or indirectly through mutual funds and pensions. But owning some stock and benefitting from the President's dividend proposal are two different things. What the Administration does not point out is that wealth, including stock ownership, is much more unequally distributed than income. In 2001, the wealthiest 10 percent of households held 70 percent of all the wealth. Those are the people who are going to get most of the benefit from the President's dividend proposal.

Some provisions of the President's plan provide tax cuts to middle class families, but middle class families fare at least as well under the Democratic alternatives as they do under the President's plan. The difference is that the Democratic alternatives are able to provide more stimulus with less long-term harm to the budget because they do not provide expensive tax breaks to very high-income taxpayers. And, unlike the Administration, they recognize that there are a million people out there who have exhausted all federal and state unemployment benefits and are still out of work, and that helping out those workers should be part of any program to get the economy moving again.

I must agree with my colleague in the U.S. Senate, Senator Breaux, who recently commented that investing in our health care system would do far more to stimulate our economy and improve the lives of real people

than anything in President Bush's latest tax cut. President Bush always finds the money for tax cuts, but falls short when it comes to Medicare, prescription drug coverage, and people's health.

Over the past two decades we have seen two different fiscal policy experiments. In the one, we enacted a large tax cut and saw budget deficits balloon. That was the 1980s. In the other, we took steps to bring down the budget deficit, including some tax increases on the richest 1 to 2 percent of taxpayers. That was the 1990s. Did it matter whether we had deficits? Here's what one textbook says:

> We can represent the large increases in the federal budget deficit in the early 1980s...creating short-run pressures for higher output and interest rates (emphasis added). By the late 1990s, an emerging federal budget surplus put downward pressure on interest rates.

That is a quote from Dr. Hubbard's textbook, Money, the Financial System, and the Economy. Like most academic economists, he recognized that a lack of fiscal discipline contributes to higher interest rates and fiscal discipline contributes to lower interest rates. I hope he would recognize that large budget deficits drain the pool of national saving, reducing the amount available for new investment or forcing us to borrow from the rest of the world, incurring an obligation that we will have to repay in the future.

It looks to me like the fiscal policies the Bush Administration is pursuing are more like those of the 1980s than they are like those of the 1990s. Of course, there is one difference. In 1982, President Reagan recognized that the tax cut that was passed in 1981 was excessive, and he scaled it back substantially.

I am looking forward to Dr. Hubbard's testimony, and I hope he addresses these concerns.

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

It is a pleasure to join in welcoming Chairman Hubbard before the Committee this morning.

A review of the data shows that the economy has not yet fully rebounded from the slowdown that began in the middle of 2000. Although GDP growth was about 3 percent during the first three quarters of the year, it lagged in the fourth quarter. Consumption has held up quite well until the last quarter, but weakness in business investment continues to be a feature of the slowdown. Employment has also been weak, with manufacturing employment, for example, falling for 29 consecutive months since the summer of 2000.

The President has proposed to accelerate already scheduled tax reductions in individual marginal income tax rates and the marriage penalty, provide a dividend exclusion for individuals, and expand expensing of investment for small business, among other things.

During 2001, many economists noted the timeliness of the first installment of tax relief, given the fact that the economy had slipped into recession. The current concerns about the pace of economic expansion indicate that accelerated tax relief now would also be appropriate. The end of the double taxation of dividends would also reduce the bias against saving and investment in the tax code, and enhance the prospects of economic growth over the long run.

Unfortunately, opponents of the President's tax proposal have misrepresented it as skewed towards the affluent. However, this argument is typically based on incomplete information taken out of context. As I have pointed out before, disclosure of the shares of taxes paid by each income group before and after a tax relief plan goes into effect is usually not made by such critics. Such information would demonstrate that the proportion of tax relief is mostly driven by the shares of taxes paid before tax relief becomes effective, and usually subsequent changes in total tax shares are quite small.

Another issue related to evaluating the impact of tax relief is income mobility. Over ten years ago this committee asked the Treasury Department to provide an analysis of the mobility of tax filers over an extended period of time. In the last Congress, I requested an updated examination of this critically important issue, and think such information would be valuable to policymakers now. There are those who persist in viewing the U.S. economy as a sort of caste system in which people are cemented into a particular income class forever. Data on income mobility demonstrate a much more flexible and dynamic reality characterized by fairly high degrees of income mobility.

Bush Tax Cuts and Projected Surpluses (billions of dollars)										
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Surplus (Projected in January 2001)	313	359	397	433	505	573	635	710	796	889
Tax Act	-38	-91	-108	-107	-135	-152	-160	-168	-187	-130
Total	275	268	289	326	370	421	475	542	609	759

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

Chairman Bennett and members of the Committee, I thank you for the opportunity to testify today on the President's Jobs and Growth Initiative. As a starting point, I would like to review the economic situation facing our Nation. In many ways, the economy's recent behavior has been different than that of past recoveries. Typically, business investment declines most sharply in recessions and expands most briskly in recoveries. By contrast, the household and government sectors do not fluctuate as much. In 2002, however, the recovery from the economic contraction in the previous year took place amid continued weakness in business investment and strength in the household sector. Weakness in investment, in turn, has reduced job growth below what is normal for this stage of the expansion. In the near term, the central challenge for the economy will be to support rising investment, so that robust job growth can resume.

Over longer horizons, the fundamental strengths of the American economy are clear. Most importantly, the productivity acceleration that began in the late 1990s continued in 2002. As Chart 1 shows, the trend rate of U.S. labor productivity growth has risen from rate of 1.4 percent per year from 1973 to 1995 to 2.5 percent per year from 1995 to 2000. Over the last four quarters for which we have data, labor productivity has risen by 5.6 percent – the best four-quarter change in productivity since the early 1970s. Because productivity growth is the key to growth in incomes and living standards, the ongoing productivity revival speaks well for the long-term outlook. Additionally, inflation remains low and stable, which helps the economy interpret relative price signals efficiently and which gives policymakers the room to support near-term growth.

GDP data for the fourth quarter of 2002, which were released earlier this morning, highlight the importance of supporting near-term growth with a fiscal policy that improves long-run outcomes as well. After rising at an annual rate of 3.4 percent during the first three quarters, GDP rose at an annual rate of 0.7 percent in the fourth quarter. Business fixed investment rose at an annual rate of 1.5 percent – the first quarterly increase since mid-2000 – but larger rates of increase will be needed for the recovery to be fully established. The role of investment in the current recovery and the importance of productivity growth in the long run provide the context for the President's jobs and growth proposals, which I will discuss extensively today. In the short term, the focused, specific proposals that the President has outlined are the most appropriate way to insure that the investment recovery proceeds as expected. In the long run, the proposals will raise long-run living standards by increasing investment and the capital stock, which will make workers more productive and thereby raise their standard of living. Before I turn to those proposals, I will review the recent performance of the U.S. economy. Doing so will illustrate how the President's proposals support

the immediate recovery as well as improve incentives for long-term growth.

THE ECONOMIC SITUATION IN 2002

Household sector. The household sector was a robust and consistent source of final demand in 2002. In large part, the strength of the household sector last year stemmed from the aggressive monetary easing by the Federal Reserve in 2001. Over the course of that year, the Federal Reserve cut its target federal funds rate eleven times, lowering the target from 6.5 percent to 1.75 percent. Given the well-known lags in monetary policy, these reductions continued to provide stimulus throughout 2002. Lower interest rates, for example, allowed motor vehicle companies to offer aggressive financing incentives, which have supported auto sales through much of the year.

Additionally, the substantial cuts in the target federal funds rate by the Federal Reserve have translated into lower mortgage interest rates, supporting housing starts and mortgage refinancing. In the first three quarters of 2002, mortgage refinancing alone injected more than $100 billion into home owners' pocketbooks. After they paid down second mortgages and outstanding home equity loans, they had more than $59 billion left over to spend in other ways. Survey evidence indicates that about half of this $59 billion was probably used for consumption and home improvements – two components of aggregate demand – which would have raised nominal GDP by about 0.4 percent in the first three quarters of 2002. All in all, the interest rates cuts were helpful in maintaining the recovery last year. The most recent rate reduction of 50 basis points undertaken on November 6, 2002, will provide further support for the recovery in 2003.

Fiscal policy has also been an important force behind robust consumption in 2002. In addition to enhancing long-term economic efficiency, the tax cut proposed by the President and passed by Congress in 2001 provided valuable support for disposable income, which has been far more robust than is typical at this stage of a recovery. The upshot has been solid growth in both personal consumption expenditures and residential investment that has supported the recovery so far.

Business investment. In contrast to positive impetus from the household sector, business investment has been the economy's key weak spot. As I noted earlier, during the current business cycle, the decline in business investment has been sharper, and the recovery more modest, than an average postwar business cycle. On average, the peak-to-trough decline in nonresidential investment in the typical post-war recession is 6.2 percent. Assuming that the trough in the most recent recession occurred during the fourth quarter of 2001 – a decision that ultimately resides with the National Bureau of Economic Research – the corresponding decline in the most recent recession was 8 percent. Comparing the typical pace of recovery, during the first three quarters of this recovery, business investment fell 2.0 percent further, compared to a typical increase of roughly 2.7 percent. Chart 2 displays the current weakness investment graphically, by comparing it to the typical

experience of recoveries since 1960. Simply put, the recovery in investment that one would expect at this stage of the business cycle has yet to materialize.

The current weakness in investment results is linked to adverse developments in equity markets during the past three years. Indeed, both stem in large part from the same underlying shock – a scaling back of expected profit growth. Evidence that earnings growth was adjusted downward comes from surveys of Wall Street analysts who track individual firms. According to one such survey, five-year-ahead earnings growth forecasts for the firms in the S&P 500 fell from a peak of more than 18 percent per year in mid-2000 to slightly more than 13 percent per year by September 2002. Another factor in lowering both equity values and business investment is the current risk climate. Higher levels of uncertainty in the economy and/or higher aversion to risk on the part of investors reduce the willingness of investors to hold corporate equities and lowers stock prices and investment. One reflection of the risk outlook is the spread between yields on corporate bonds and U.S. Treasury securities, because corporate bonds are subject to default risk while U.S. Treasuries are not. The widening gap between yields for corporate and Treasury securities after 2000 coincided closely with the decline in the stock market during this period. Spreads continued to widen sharply in 2002, reaching near-record levels, indicating that risk aversion played a key role in markets in the months following September 11, 2001 as well.

Inventory investment contributed strongly to the economic slowdown in 2001, but by early in 2002, the pace of inventory decline slowed, providing a significant boost to production. In some sectors of the economy, evidence suggests that inventory restocking is underway. Over the next several quarters, as inventory and sales growth come together, inventory investment's role in real GDP growth should provide upward momentum to the recovery.

Government purchases. The war on terror continued to exert upward pressure on Federal government purchases in 2002. In late March, for example, the President requested that Congress provide an additional appropriation of $27.1 billion, primarily to fund the effort in the war against terror. More than half of this amount was allocated to the activities of the Defense Department and various intelligence agencies. Most of the rest was needed for homeland security (mainly for the new Transportation Security Administration) and for the emergency response and recovery efforts in New York City. Though most of this spending was required for one-time outlays only, it nevertheless contributed to the large 6.4 percent annual rate of increase in real Federal government purchases in the first three quarters of 2002. State and local government purchases rose by a more moderate 1.7 percent annual rate during the same period.

External sector. While the United States economy remained below potential in 2002, its growth rate still outpaced that of many other industrialized countries. Growth in Canada – America's largest trading partner – was a healthy 4.0 percent in during the four quarters ending in

the third quarter of 2002, but growth in many other countries, such as Mexico, France, Japan, and Italy lagged behind. Low demand for U.S. exports combined with the emerging recovery in the United States (and the subsequent increase in the U.S. demand for imports) caused the U.S. trade deficit to reach record levels in 2002.

The widening trade deficit placed additional downward pressure on the U.S. current account, which reached almost five percent of GDP in the middle of 2002. As a matter of accounting, the current account is simply the difference between net domestic investment and net domestic saving. Several factors can raise the current account deficit, including higher investment in the within our borders on the part of foreign investors, or lower savings rates on the part of U.S. citizens. In light of the large number of trade-related and financial forces operating on the current account, it is impossible to label a current account deficit as either "good" or "bad." Indeed, one factor contributing to high U.S. investment relative to savings is the rapid increase in U.S. productivity relative to many other major countries, which makes the United States a good place to invest. Because productivity growth is ultimately responsible for rising living standards, the current account deficit reflects at least in part good news about the American economy. Even so, a current account deficit indicates that the United States is consuming and investing more than it is producing, and the U.S. current account has typically been in deficit for the past two decades. As a result, the net international investment position in the United States has moved from an accumulated surplus of slightly less than 10 percent of GDP in the late 1970s to a deficit of almost 20 percent of GDP in 2001.

Recent increases in the current account deficit have led to some concerns that continued current account deficits (and the subsequent increases in international debt that would result) could not be sustained. Because debt has to be serviced by the repatriation of capital income abroad, the ratio of a country's debt to its income must stabilize at some point. Yet the U.S. is currently far from the point at which servicing our international debt becomes burdensome. In fact, until 2002, more investment income was generated by U.S. investment in foreign countries than was generated by foreign investments inside the United States.

In the end, the key determinant of the sustainability of the U.S. international debt position is continued confidence in the economic policies of the United States. As long as the United States pursues its current market-oriented, pro-growth policies, then the current account deficit will not represent an impediment to continued economic growth.

Labor market. The unemployment rate hovered between 5.5 and 6.0 percent throughout the year after rising 1.8 percentage points in 2001. Nonfarm payroll employment in 2002 was similarly weak, with 181,000 jobs lost in 2002, compared with 1.4 million jobs lost the previous year.

As in past business cycles, declines in manufacturing employment have been especially pronounced. Factory employment fell 592,000 in 2002, following a decline of 1.3 million in 2001 and about 100,000 in 2000. Another feature of previous business cycles that has recurred in the past two years is the increase in the number of workers

who report a long unemployment spell. Like the overall unemployment rate, the number of workers unemployed for 26 weeks or more rose in the 2001 and remained high in 2002. Yet the pattern of long-term unemployment observed in 2001 and 2002 was similar to patterns traced out in previous postwar fluctuations. Like the overall unemployment rate, the level of long-term unemployment remains moderate relative to past business cycles.

RISKS TO THE OUTLOOK

The slowing of GDP growth and weakness in labor markets in the fourth quarter of 2002 highlight the risks the recovery currently faces. In order of importance, these risks include:

A Delayed Investment Recovery. The key to transforming the current recovery into sustained robust growth is an increase in the pace of business fixed investment. Only with robust business investment will labor markets improve. A recovery in investment is a key factor in creating more jobs because when companies build new factories, they hire directly and boost employment in capital-goods industries.

While private forecasters expect business investment spending to recover in 2003, there are several potential sources of a delay in an investment recovery. One risk is weaker profit growth. Due to a sharp increase in the fourth quarter of 2001, corporate profits have rebounded from recessionary lows. (This is the most recent quarter for which we have data on corporate profits.) Yet the recovery in profits has been uneven. In the first three quarters of 2002, profits as a share of income averaged 7.5 percent. While this represents a recovery from the 7.2 percent share in 2001, it is still below shares of 8.7 percent in 1999 and 7.9 percent in 2000. Moreover, on a quarterly basis, corporate profits declined in each of the first three quarters of 2002. Because current profits are an indicator of future profits, firms may interpret recent weakness in profit growth as an indication of reduced investment opportunities. Moreover, the decline in profits may have an even more negative impact on investment at firms that depend on retained earnings (rather than external capital markets) to fund investment projects.

A second potential setback to the investment recovery reflects an increase in the level of uncertainty about the course of the near term events or higher levels of risk aversion on the part of investors. Higher levels of uncertainty in the economy can also make firms delay new projects until the uncertainty is resolved. This delay is translated into a higher expected rate of return in order for new projects to be undertaken, which reduces the level of investment that is undertaken in the near term. Additionally, higher levels of risk aversion on the part of investors can reduce investment by making it harder for firms to raise external funds.

A Decline in Consumer Spending. As mentioned, the recent business cycle stands apart from the typical postwar recession in that household income growth has been stable while stock price declines have eroded household wealth. In the typical recession, incomes and net worth move together, but in the most recent recession, net worth fell dramatically relative to income. Yet in contrast to the negative effect of

lower equity values on business investment, consumption has remained remarkably robust, even as household net worth has suffered. The contrast in the pattern of spending mirrors a reversal of conventional income and wealth dynamics. In the current cycle personal income – especially disposable personal income, supported by the tax cuts of 2001 – has held up quite well, even as household balance sheet positions have weakened.

The deterioration in household wealth over the past three years raises the possibility that consumers will increase their active saving out of disposable income in order to restore at least some of their lost wealth. An increase in precautionary saving of this type could have a substantial effect on yearly consumption. From the first quarter of 2000 to the last quarter of 2002, households lost nearly $7 trillion in equity wealth. A rough rule of thumb suggested by aggregate data on wealth and consumption is that yearly consumption declines by 3 to 5 cents for every dollar of lost equity wealth. Based on the midpoint of this range, the $7 trillion reduction in equity wealth since early 2000 would be expected to eventually lower yearly consumption by about $280 billion per year. For comparison, a reduction of this amount would represent nearly 4 percent of consumption and almost 3 percent of GDP in 2002.

Empirical findings also suggest that response of consumption to stock market wealth is drawn out over time, a fact which has crucial implications for the precise path of consumption over the next few years. Because the appreciation of equity prices before 2000 would be expected to increase consumption, some of the implied $280 billion drop in consumption after 2000 may simply represent a "cancellation" of an implied consumption increase that had not yet taken place. Moreover, positive influences from the other determinants of consumption (such as current income and the continuing appreciation in housing wealth) are likely to offset the stock market's negative effects on personal spending. Even so, the possibility that consumers might pull back somewhat represents a risk to the recovery in the near term.

An Increase in Oil Prices. Oil prices trended upward in 2002, with the spot price of the benchmark West Texas Intermediate rising from about $20 per barrel at the start of the year to about $32 by year's end. Much of the increase was due to the recent turmoil in Venezuela. The general strike in that country began in the first week of December; since then, the WTI price has risen from around $27 dollars per barrel to about $33 dollars per barrel today. Concerns over the failure of the Iraqi regime to disarm in a credible way may have also been partly responsible for the increase in oil prices in 2002.

The effect of further oil price increases on the economy is difficult to determine. To be sure, there are "rules of thumb" that are often used to quantify the effect of export disruption on oil prices as well as the subsequent effect of higher oil prices on GDP. For disturbances of a few million barrels per day, a reduction of oil supplies of one million barrels per day typically raises prices by about 3 to 5 dollars per barrel. Additionally, a sustained increase in oil prices of $10 per barrel would be expected to lower GDP growth by about 0.25 to 0.50 percentage points

after six months to one year. While these rules of thumb are useful guideposts, the actual effect to the economy could vary greatly from episode to episode. For example, a disruption of oil production that was that was expected to last indefinitely would affect prices differently from one that was likely to be unwound quickly. Moreover, if higher oil prices accompany a serious deterioration in consumer and business confidence, their ultimate effect on GDP could be much larger than a simple rule of thumb would suggest.

THE PRESIDENT'S JOBS AND GROWTH INITIATIVE

In light of the risks to the near-term outlook, the President has advanced a proposal to enhance long-term growth while providing near-term support against downside risks to the Nation's economic outlook. It is important to note that the recovery is not in immediate jeopardy. Private forecasters expect the recovery to gather momentum over the coming year, with both higher investment and improved job growth. Yet the presence of current risks suggests that insurance against unforeseen deterioration in economic activity is especially valuable. The best proposals are those that will raise the rate of long-term growth even if the recovery takes shape as private forecasters anticipate.

The President's proposal targets the areas that are most fundamental to the continued health of the current recovery – investment, consumption, and job growth. Specifically:

1. Accelerate to January 1, 2003 features of the 2001 tax cut currently scheduled to be phased-in: the reductions in marginal income tax rates, additional marriage penalty relief, a larger child credit, and a wider 10 percent income tax bracket.
2. Eliminate the double taxation of corporate income, whether this income is paid out to individuals as dividends or retained by the firm. Dividend income will no longer be taxable on the individual level, while a step-up in basis will be allowed in order to reflect the effect of retained earnings on share prices.
3. Increase to $75,000 the size of small business investment incentives – the amount that they may deduct from their taxable income in the year the investment takes place.
4. Provide $3.6 billion of funds to the states to fund Personal Reemployment Accounts. These accounts provide up to $3,000 to assist unemployed workers who are likely to need help in finding or training for a new job. If a new job is found quickly, the unspent balance in the account can be kept as a "reemployment bonus."

How the Proposals Will Help the Economy in the Near Term

Supporting investment. To be effective in aiding the current recovery, any proposal must support investment. The President's proposals do this in three ways: ending the double taxation of corporate

income, raising the expensing limits for small businesses, and lowering individual marginal tax rates (which are the relevant tax rates for small firms that pass through their income to their owners).

The most immediate effect of ending the double taxation of corporate income will be to lower the cost of capital faced by firms in equity markets. Under the double taxation inherent in the current law, investment projects funded with new equity capital face effective federal taxation of up to 60 percent. The President's proposals address this problem by removing the layer of tax at the individual level. Corporate income will be taxed once – and only once – which will make corporate equities more attractive to investors and lower the implicit cost that firms pay for equity-financed investment. As an example, the cost of capital for equity-financed equipment investment in the corporate sector would fall by more than 10 percent. For investment in structures – the weakest part of the investment outlook today – the decline in the cost of corporate equity capital would be more than one-third. For equipment investment, this decline in the cost of capital is equivalent to an investment tax credit of from four to seven percent.

In addition to the direct stimulative effects of lower costs of equity capital, ending the double taxation of corporate income will rationalize dividend payout policy among American companies. This will also aid investment, even in the short run. Currently, the tax code encourages firms to retain earnings and remit income to shareholders through share repurchases. This gives firms an incentive to inflate their reported earnings, so that their stock prices will rise. A main goal of the President's policy is to reduce this incentive by making tax policy neutral with respect to retaining earnings or paying dividends. Firms wanting to transmit their profitability to outside investors need only show them the money, in the form of dividend checks. With less uncertainty about the true profitability of firms, investment funds will flow more easily to firms with good investment prospects. This will not only make financial markets more efficient, but – like the reduction in the equity cost of capital – rational payout policy may also raise the total level of investment as well.

Other parts of the proposal support investment for smaller firms. Small firms will be allowed to expense up to $75,000 in new investment, which will lower the tax-adjusted cost of capital significantly. Eligibility for this immediate deduction would begin to phase out for small businesses with investment in excess of $325,000, which is increased from $200,000. (Both the expensing limit and the phase-out range will be indexed to inflation.) Additionally, the acceleration of the marginal tax rate reductions will help firms that pass-through earnings to their owners. According to the Treasury Department, more than 30 million individual returns listed small business income in 2000. Virtually all of these firms will enjoy marginal tax relief by accelerating the rate reductions which have already been approved by Congress.

Supporting consumption. Consumption accounts for about two-thirds of economic activity, and consumption spending must remain vigorous if the recovery is going to continue. The President's proposals

will accelerate the tax relief that has already been enacted, which will put more money in the pockets of consumers this year – when it is needed most. The Treasury estimates that calendar-year tax liabilities will be reduced by almost $100 billion in 2003. Of this amount, about $29 billion will be due to the marginal rate reductions, while another $16 billion will result from the acceleration of the increase in the child credit. On a "cash-out-the-door" basis, the proposal as a whole will infuse around $52 billion into the economy this year, and tax savings for individual families will be substantial. A typical family of four with two earners making a combined $39,000 in income will receive a total of $1,100 in tax relief under the President's plan.

As with any attempt to increase economic activity with a tax cut, an important question is how much of the cut will actually be spent. An acceleration of the marginal tax reductions the 2001 tax cut is likely to result in significant spending increases, because the acceleration is done in the context of long-term tax relief. Delivering tax relief now, rather than in 2004 and 2006, sends a message that the government will meet its commitment to the American people to allow them to keep more of what they earn. As taxpayers realize that their long-term disposable income has risen, their spending plans will rise as well. By contrast, tax policy based on temporary changes to tax rates, or one-time tax rebates, has rarely worked as advertised. A temporary tax increase did not rein in the economy in 1968, a temporary tax cut did not stimulate the economy in 1975, and a temporary tax cut is not the right policy for 2003. Former Federal Reserve governor and CEA member Alan Blinder has written that in the year after enactment, a temporary tax cut has only about half the effect of a permanent tax cut.

Supporting job growth. The best policies for improved job growth are those that insure the economy itself will continue to grow. Still, government policy can affect the rate at which unemployed workers find and train for the jobs that a growing economy provides. The Re-employment Accounts in the President's proposal build on the existing Workforce Development System and empower unemployed workers by giving them more flexibility and personal choice over their assistance. Unemployed workers have a wide range of needs and are best-suited to understand their particular circumstances. Some workers may want extensive retraining. Others may not require retraining, but may need help relocating or may need child care while looking for work. Economists have long recognized that except in rare circumstances, giving individuals choices over how to spend their money improves their welfare. In this case, giving unemployed workers a choice of whether to receive training or to receive alternative services for which they may have a greater need will not only improve the efficiency of government services (by matching unemployed workers with the services they need most), it will improve unemployed workers' welfare at the same time.

The potential to receive a reemployment bonus would provide eligible workers a greater incentive to find new employment. At various times from 1984 to 1989, four states—Illinois, New Jersey, Pennsylvania,

and Washington—conducted controlled experiments to determine the effectiveness of providing reemployment bonuses to unemployed workers. In these experiments, a random sample of new UI claimants were told they would receive a cash bonus if they became reemployed quickly. The advantage of these experiments is that the effect of offering a reemployment bonus on the duration of unemployment and on earnings upon reemployment can be directly evaluated by comparing the experiences of UI claimants randomly chosen to be offered a reemployment bonus with those of UI claimants not chosen for the bonus (who received the regular state UI benefit).

An evaluation by the Department of Labor of the reemployment bonus experiments conducted in the states of Washington, New Jersey, and Pennsylvania showed that a reemployment bonus of $300 to $1,000 motivated the recipients to become reemployed, reduced the duration of UI by almost a week, and resulted in new jobs comparable in earnings to those obtained by workers who were not eligible for the bonus and remained unemployed longer. Similarly, a study of the experiment conducted in Illinois—and published in a leading American economics journal—found that a reemployment bonus of $500 reduced the duration of unemployment by more than a week and did not lead to lower earnings at the worker's next job. Therefore it is likely that giving unemployed workers the option of receiving the unspent balance in their Personal Reemployment Accounts will provide them an incentive to find a new job quickly, reducing the time spent unemployed, but will not result in workers taking lower paying jobs than they would get if they searched longer.

How the Proposals Will Help the Economy in the Long Run

In the near term, the President's proposal insures that the recovery proceeds by supporting investment. In the long run, the higher investment delivered by the plan leads to higher productivity – the fundamental source of higher standards of living for American workers. Economists have long known that from the workers' point of view, the optimal rate of capital taxation is no taxation at all. The reason for this surprising result concerns the burden, or "incidence" of the capital tax. An investor with an extra dollar to spend can either use it to fund consumption today or save it to fund a larger amount of consumption later. His or her preferences for consuming now versus consuming later determine how much extra consumption he or she must enjoy in the future in order to resist consuming the dollar's worth of goods and services today. Lowering the capital tax means that investors receive much larger after-tax returns on their investments. This change in returns makes it more likely that households will defer consumption and invest, which will raise the amount of savings available to firms that want to borrow in financial markets. As firms invest more, the amount of capital that workers available to workers goes up, as does their productivity. In the end, higher productivity raises workers' wages and their standard of living. This line of reasoning shows that even though workers may not write a check to the IRS for dividend taxes, all of us as workers still pay

part of the dividend tax in the form of lower wages, because the dividend tax reduces the amount of capital in the economy.

Workers enjoy long-run gains from the President's proposals in other ways as well. Marginal rate reductions and permanently higher expensing limits for small business will also raise investment, which in turn raises productivity and wages for the same reasons outlined above. The rationalization of dividend payout policy will improve corporate governance and place corporations on equal footing with non-corporate users of capital. Both of these developments will improve the efficiency of markets. (A 1992 Treasury Department report on the double taxation of corporate equity showed that the reallocation of capital toward more efficient uses would permanently raise economic well-being by the equivalent of $36 billion worth of consumption per year in today's dollars.) Additionally, ending the double tax in the way in which the President has suggested will increase economic efficiency by reducing the incentives for corporations to engage in tax sheltering activities, because only income on which corporate taxes have been paid can be transmitted to shareholders tax free.

Effect on national saving and budget balance. Some critics of tax relief have argued that now is not the time to cut taxes, but to raise them. The view is that if the government adopts deficit reduction as its number one goal, growth will somehow follow. I disagree. To begin with, surpluses tend to follow growth, not the other way around. Raising taxes may lower the deficit, but this is not equivalent to spending restraint that limits the size of government in the economy and lets the private sector create jobs. Moreover, tax relief of the size that the President has suggested does not significantly worsen the government's fiscal position. One way to judge the effect of tax proposals on the government's fiscal position is to view them in the context of a "fiscal anchor," such as the debt-to-GDP ratio, or the share of Federal outlays that go to service the government's debt. By either of these measures, the tax relief offered in the President's proposals remains sound policy. For example, the proposals would raise the debt-to-GDP ratio by less than one percentage point in the year of adoption, and the debt-to-GDP ratio would decline in the out-years of the budget window.

CONCLUSION

Though the long-term fundamentals for the U.S. economy are strong, we still face a number of challenges. The recovery which began in the fourth quarter of 2001 must be maintained, and fiscal policy must remain on sound foundation. By focusing on the economy's most uncertain component – business investment – the President's proposals insure that the recovery will proceed. Chart 3 shows that the President's proposals will raise the level of real GDP by 0.9 percent by the end of 2003, assuming that the proposals take effect in the middle of the year. At the end of 2005, the level of GDP will be 1.8 percent higher. Although the proposals focus on the economy's near-term needs, they also promote stronger growth in the long term as well. In doing so, they

Chart 1: Labor Productivity (Nonfarm Business Sector)

Index, 1992 = 100 (ratio scale)

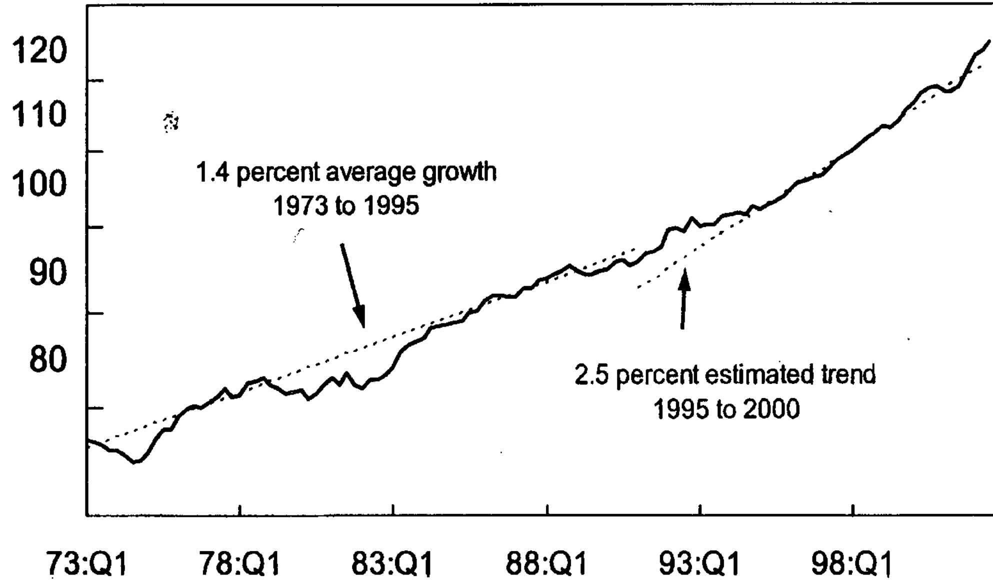


Chart 2: Real Nonresidential Fixed Investment

Trough = 1

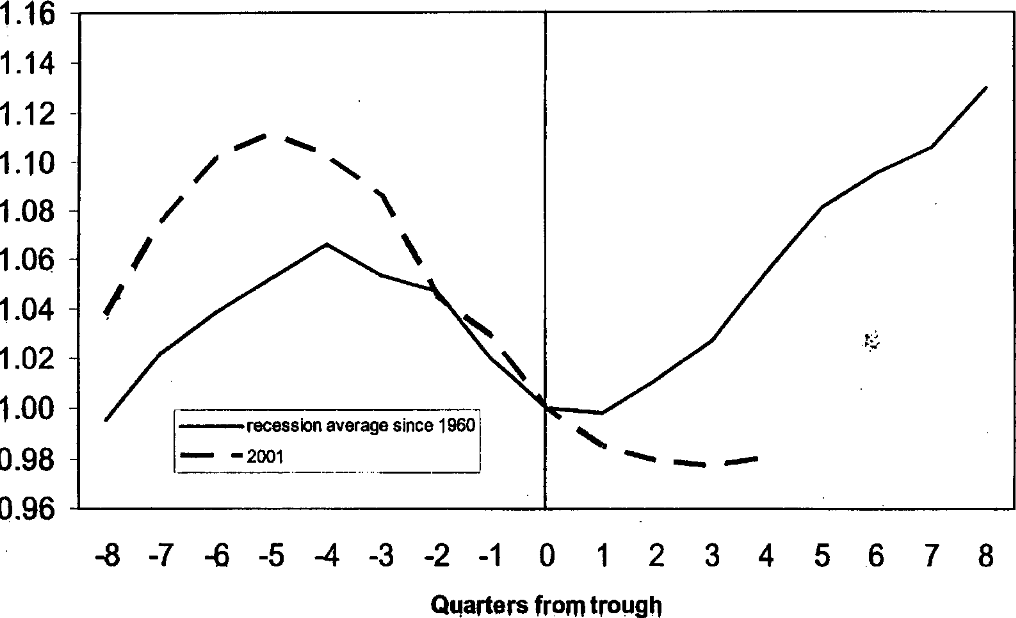
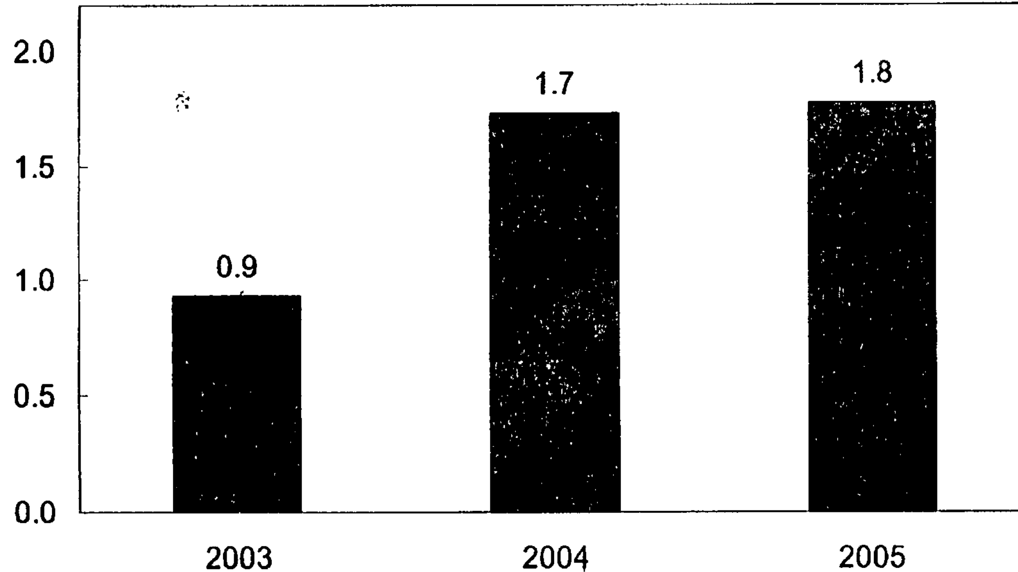


Chart 3: Growth Package Effect on Real GDP Baseline Forecast

Percentage difference from baseline at end of fourth quarter



PREPARED STATEMENT OF SENATOR EDWARD M. KENNEDY

I commend our Chairman, Senator Bennett, for his leadership in holding this hearing on the Administration's Jobs and Growth Plan, and I join in welcoming Dr. Hubbard to the Joint Economic Committee.

Many of us in Congress have continuing concerns about the Administration's economic record and its responses to the challenges facing our economy. Many families are asking themselves the question, "Are we better off than we were two years ago"? For most Americans their response is "No".

The principal proposal that President Bush has put forward to strengthen growth is to reduce taxes for the wealthy. In doing so, the Administration's plan does not recognize the basic needs of most Americans and their widespread concerns about the economy. Massive tax breaks that benefit corporations and the wealthy, while shortchanging essential priorities such as protecting social security and investing in health care, education and job training, homeland defense and public safety are not what the nation needs.

Only two years ago, the national unemployment rate was 4 percent - - not 6 percent as it is now. The ranks of the uninsured and the poor were falling - - not rising, as they are now. Workers were building retirement savings and planning for the future - - not worrying about whether their jobs are secure or how to restore lost savings in the stock market, as they are now. The states had budgets with record-setting surpluses, not ballooning deficits that require cuts in basic services or new tax increases.

The economy has declined significantly under the leadership of President Bush. The nation has lost 1.7 million jobs over the past two years after adding 5 million jobs in 1999 and 2000. Last month alone, we lost over 100,000 jobs – the biggest monthly decline in nearly a year. According to the Department of Labor, there are 2.5 job seekers for every job opening. Unemployment is at an eight-year high and expected to grow. Ten million unemployed workers want jobs but cannot find them. The uncertainty generated by a possible war against Iraq is affecting the economy.

The number of long-term unemployed - - those out of work for more than 6 months - - has now soared to nearly 2 million – a 70 percent increase from last year. More than half those workers will receive no help under the law signed by the President earlier this month, even though they have run out of their state and federal unemployment benefits and still don't have jobs.

The ranks of those without health insurance rose to more than 41 million in 2001. An estimated 300,000 individuals lost health coverage during the first six months of 2002. Most Americans without health insurance – 80 percent – are in working families, and workers who still have health insurance are paying substantially more for it. Workers' premium payments rose 27 percent for single coverage and 16 percent for family coverage during the first six months of 2002. Most employers are passing along higher costs to workers in 2003 and plan to do so next year.

The crisis in state and local budgets has forced drastic cuts with harsh consequences. Budget shortfalls have required school districts in Oregon to cut school weeks by a day. Many states have cut Medicaid, reducing health care for as many as one million low-income Americans. Many cities are closing fire stations and laying off police officers and firefighters, who are our first responders in case of terrorist attacks.

The President's answer to this continuing economic crisis and the deep concern of America's families is another flawed and unfair trillion-dollar tax plan heavily tilted toward the very rich. The President's plan will not create jobs, will not improve schools or public safety or homeland defense, will not restore health coverage or retirement savings for workers and their families, will not help the states, and will not strengthen and protect social security.

The President's proposal is not a serious economic stimulus package. A true stimulus plan should meet three key criteria: It should accelerate short-term temporary economic growth, provide new jobs and opportunities for Americans. It should be temporary to avoid damage to the nation's long-term finances. It should provide needed assistance for state governments that offer a safety net for our most vulnerable citizens.

Obviously, Congress is sharply divided on these issues. Most Republicans want more tax cuts targeted primarily on wealthy individuals and corporations. Most Democrats want more resources for education, health care, homeland defense and other key domestic priorities. Instead of seeking a victory of party, both sides should do what's right for the country. A sensible compromise makes sense. Together, Congress and the Administration should determine how much we can afford overall, based on ten-year budget estimates, and then allocate half to tax cuts – including the President's recent proposal and the portion of the tax cuts already enacted that have not taken effect – and half to other important priorities.

I am hopeful that the President will work with Congress to find common ground on a genuine economic stimulus plan. This approach will demonstrate our new bipartisan common purpose for America. It will be fiscally responsible. It will strengthen our economy for the long-term, while we fairly address the most pressing needs of our society and our national security.

The Senate Democratic economic plan is based on three common-sense principles: it includes immediate tax cuts to promote economic growth and a return to job creation this year; it focuses on middle class families; and it is fiscally responsible in the future, maximizing our nation's flexibility to meet the challenges of the future.

The plan puts more money into the hands of the people who will spend it, provides tax incentives to businesses to invest and create jobs immediately, and channels money to states and local governments to head off state tax increases and cuts in critical services. It provides more than three times the economic stimulus in 2003 compared to the Bush plan, but at a fraction of the 10-year cost. The Democratic plan costs $141 billion in 2003 and $112 billion over 10 years.

Our plan provides a real economic stimulus by providing an immediate broad-based tax cut of $300 for each adult in a family and $300 for the first two children. That means a $1,200 tax cut for a family of four. It will return $71 billion to American taxpayers in 2003 – more than twice the amount under the entire Bush "stimulus" package for this year. It will extend unemployment benefits to the 1 million people who have exhausted their benefits but still cannot find work.

Our plan has incentives to encourage businesses to invest and create jobs, including a 50 percent bonus this year for equipment depreciation. It triples the amount that small business can expense this year. It also contains health care tax credits for small businesses, and the broadband tax credit.

Finally, our plan provides $40 billion in immediate aid to state and local governments. States are facing their worst budget crisis since World War II. In fiscal years 2002 through 2004, the states have been - - and will face deficits totaling $171 billion. Massachusetts is facing a budget deficit of $1 billion. A major part of any plan should be relief to state and local governments.

I urge the Administration to work with Congress to include these proposals as part of an effective economic stimulus plan to benefit all Americans. The economy will benefit, and so will all our citizens.