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

**before the**
**Special Committee on Aging**
**United States Senate**

**Tuesday, February 4, 2003**
**10:00 a.m.**

Chairman Craig, Ranking Member Breaux, and members of the Committee, I thank you for the opportunity to discuss how the President's Jobs and Growth Initiative will affect America's seniors. The central role of the package is to support near-term economic growth at the same time it improves the long-run productivity of the economy. This approach to fiscal policy is appropriate in the short run, because it focuses on what the economy needs now—faster investment and higher job growth for today's workers. By raising long-run economic growth, the package will help America's seniors as well. To start with, ending the double tax on corporate income will directly benefit seniors who receive dividend checks. About half of all dividend income goes to America's seniors, who often rely on these checks for a steady source of retirement income. But just as important as increasing after-tax dividend income is the effect that the President's package will have on the overall productivity of the economy. Higher taxes on corporate capital act to reduce investment, which in turns lowers the amount of capital that workers can use at their jobs. With less capital, workers are less productive, so they are paid less. By ending the double tax on corporate income and permanently raising expensing limits for small firms, the President's package encourages investment. This starts the virtuous circle of higher investment and job growth today, with higher capital stocks, productivity, wages, and standards of living tomorrow. In the end, the more productive economy will be better able to support the large number of workers who will soon retire.

Because so many seniors depend on Social Security and Medicare, any discussion of how the proposal will affect seniors must also discuss how it affects the government's fiscal position. One of the most important lessons of the past several years is the importance of strong economic

growth for the Federal government's fiscal health. Accordingly, the central role for fiscal policy is to craft a tax policy that reduces tax-based distortions that hinder growth, while at the same time limiting the growth of government outlays to a sustainable path. Given the importance of economic growth to the government's fiscal position, I will start my testimony today by reviewing the economic situation currently facing our Nation. I will then discuss the ways in which the President's proposals contribute to higher growth, specifically by targeting business spending on investment.

At the start, however, I would like to stress an important fact: While the past two years have presented many challenges to the American economy – the long decline in the stock market and the terrorist attacks and economic contraction in 2001 – our long-run economic outlook is as strong as it has been in a generation. 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. Because higher productivity growth is the foundation of higher incomes and living standards, the productivity acceleration is good news for all of us. What is more, 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. 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.

**THE ECONOMIC SITUATION IN 2002**

In many ways, the economy's recent performance has been different than that of past recoveries since World War II. 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 of the previous year took place amid continued weakness in business investment and strength in the household sector. 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 in the fourth quarter – the first quarterly increase since mid-2000 – but much larger rates of increase will be needed for the recovery to be fully established.

*Household sector.* 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 four quarters of this recovery, business investment fell 1.9 percent further, compared to a typical increase of roughly 5.3 percent four quarters into a recovery. 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. Treasury securities 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. Corporate-Treasury 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 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, it nevertheless contributed to the large 7.3 percent annual rate of increase in real Federal government purchases in 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, including Mexico, France, Japan, and Italy lagged behind. Low demand for U.S. exports combined with the emerging recovery in the United States (and the consequent increase in 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 balance, which reached a deficit of almost five percent of GDP in the middle of 2002. As a matter of accounting, the current account balance is simply the difference between net domestic investment and net domestic saving. Several factors can raise the current account deficit, including higher investment 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 United States 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 2002 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 nearly 600,000 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 27 weeks or more rose in the 2001 and 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—when companies build new factories, they hire new workers 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. 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. 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 the response of consumption to changes in stock market wealth is drawn out over time, 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, the 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, the proposal will:

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 amount that small businesses may deduct from taxable income in the year that 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 businesses 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 rates of 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 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 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—may also raise the total level of investment.

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 in 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 at most 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 Reemployment 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 with childcare 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 other 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. This evidence suggests that giving unemployed workers the option of receiving the unspent balance in their Personal Reemployment Accounts will provide 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.

*Total effect on the economy*. As chart 3 shows, CEA estimates that the package would raise the level of real GDP at the end of 2003 by 0.9 percent above the level it would have been absent the proposal. At the end of 2004, the level of real GDP would be 1.7 percent higher than it would have been without the proposal, and 1.8 percent higher than otherwise at the end of 2005. Put in terms of GDP growth rates measured from the fourth-quarter of 2002 to the fourth-quarter of 2003 and so on, the package will deliver an additional 1.0 percentage points of higher growth in 2003 than would have been the case otherwise, and an additional 0.8 percentage points of higher GDP growth in 2004. This increase in GDP will immediately put more Americans back to work, delivering about 510,000 jobs in the second half of 2003 alone. The plan will create another 891,000 new jobs in 2004. The plan works so well because it is focused on what the economy needs now—it encourages an investment rebound while supporting continuing growth in consumption.

**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 best level 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 larger after-tax returns on their investments. This change in returns makes it more likely that households will defer

consumption and instead 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 available to workers goes up, as does their productivity. In the end, higher productivity raises workers' wages and standards 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 double tax on corporate income such as dividends in the form of lower wages, because the 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 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 raise economic well-being in every year in the future by the equivalent of $36 billion worth of consumption 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.

**The Effect of the Proposals 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. Standard models of the economy suggest that an increase in debt of $200 billion dollars would raise long-term interest rates by 3 to 5 basis points. This modest increase in interest rates must be set against the large costs that a current tax increase would entail – higher distortions on saving, risk-taking, and entrepreneurship, as well as the loss of credibility that comes when the government reneges on its promise to provide Americans with tax relief.

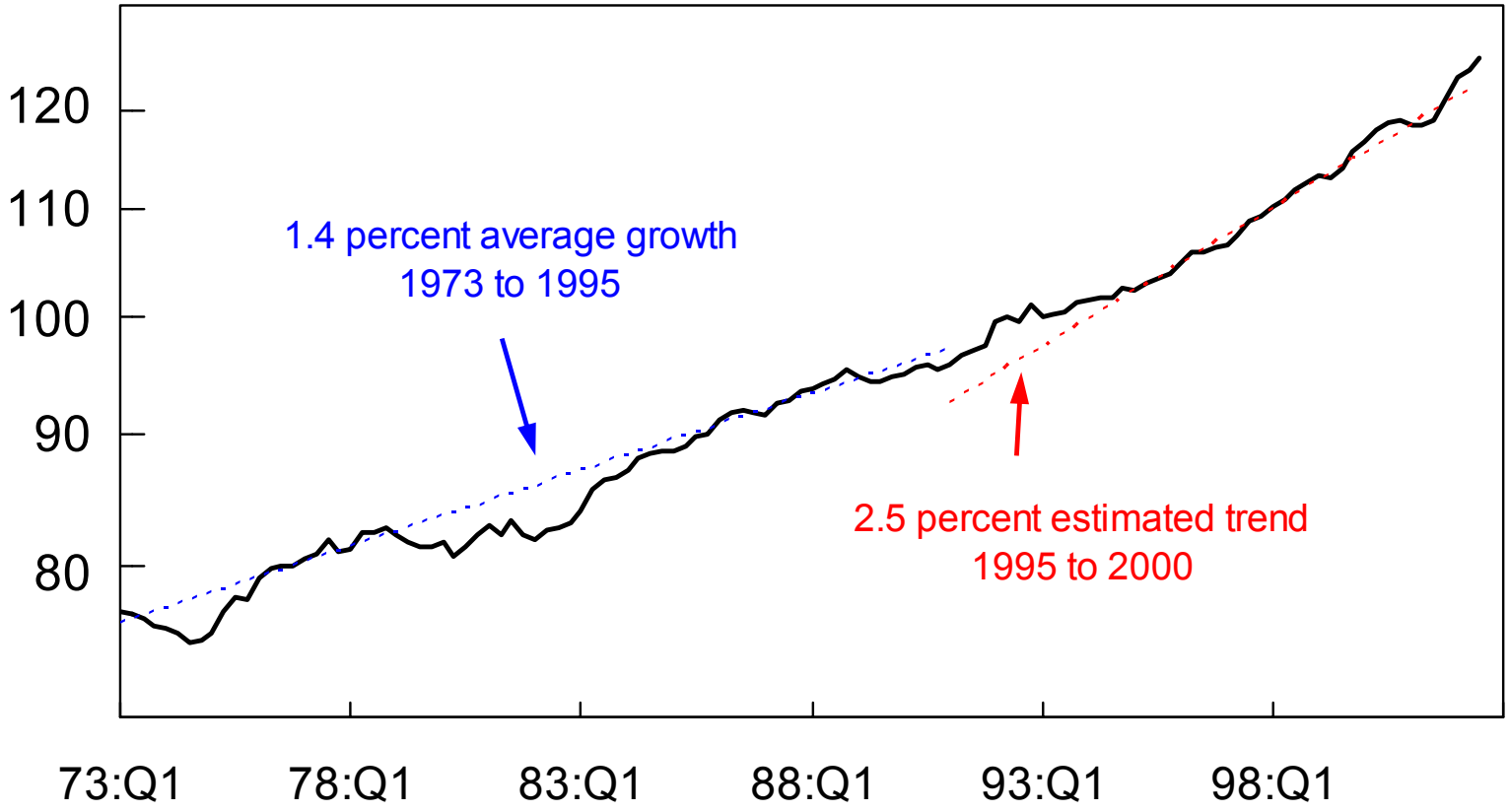
In addition, the tax relief the President suggested in his January proposal does not significantly worsen the government's fiscal position. One way to judge the effect of tax proposals on the government's fiscal position is to view them in the context of a "fiscal anchor," such as the debt-to-GDP ratio, or the share of federal outlays that go to service the government's debt. Even with the President's proposal, the debt-to-GDP ratio does not rise in the out-years of the budget window. Moreover, the effect on the proposal on debt service costs is small. According to either of these potential fiscal anchors, the tax relief offered in the President's proposals remains sound policy.

**CONCLUSION**

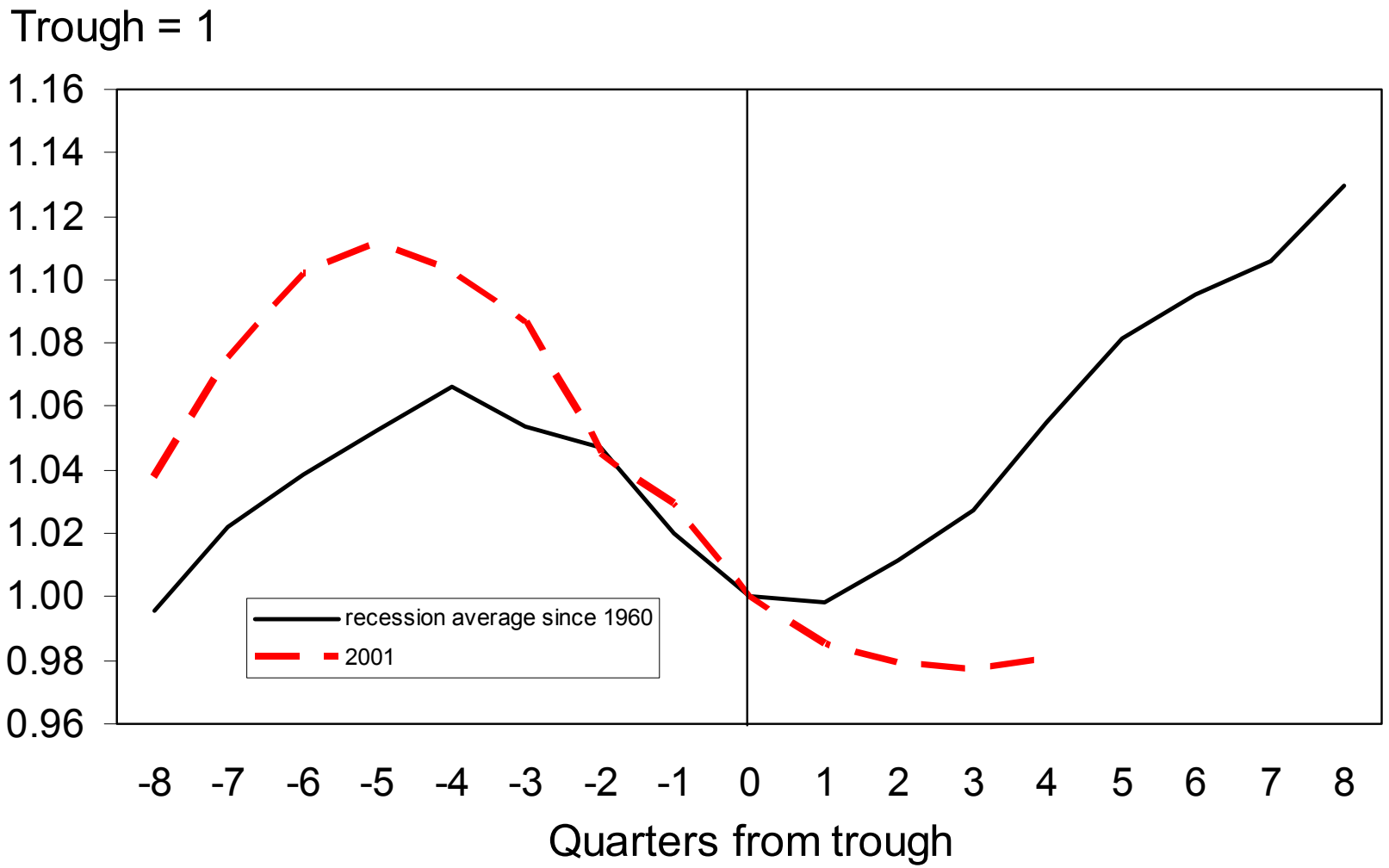
Though the long-term fundamentals for the U.S. economy are strong, we still face a number of challenges. The recovery which began in the fourth quarter of 2001 must be maintained, and fiscal policy must remain on sound foundation. By focusing on the economy's most uncertain component – business investment – the President's proposals insure that the recovery will proceed. 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 insure that the standard of living enjoyed by American workers will continue to improve in the coming years.

# Chart 1: Labor Productivity (Nonfarm Business Sector)

Index, 1992 = 100 (ratio scale)

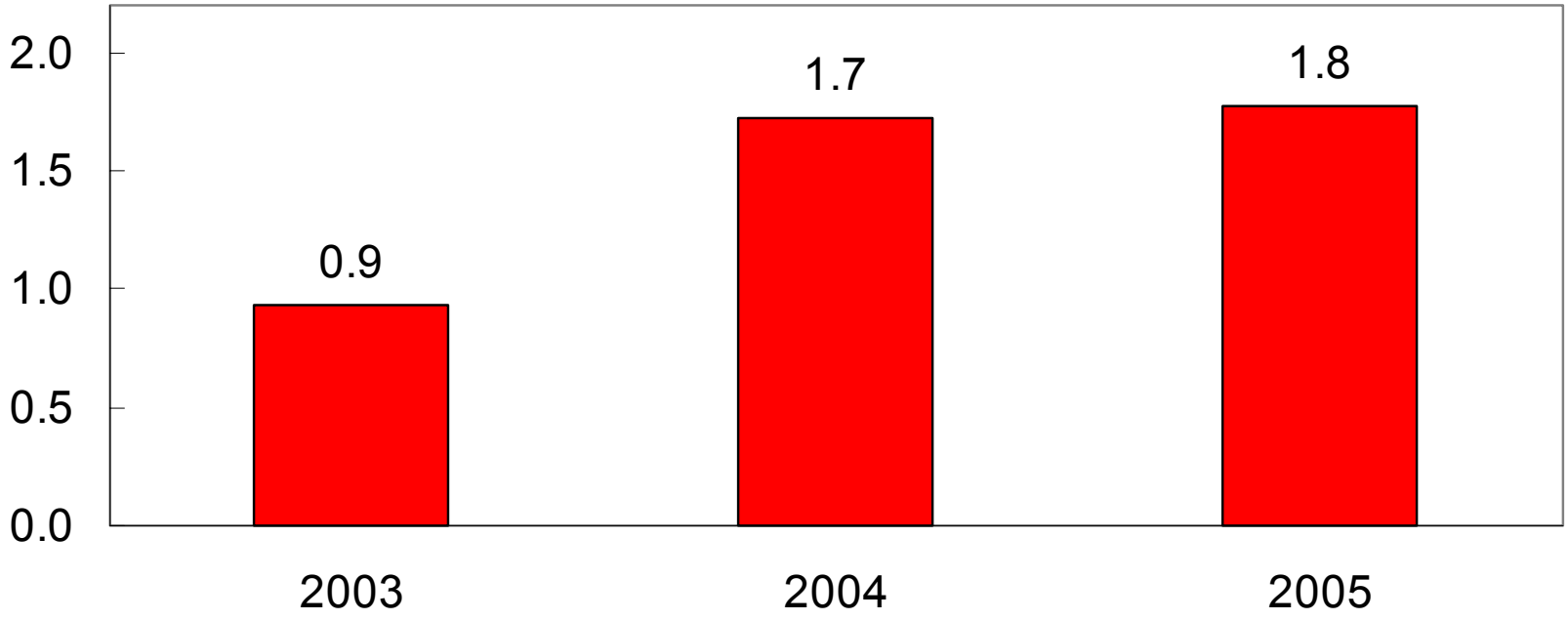


# Chart 2: Real Nonresidential Fixed Investment



# Chart 3: Growth Package Effect on Real GDP

Percentage difference of the level of real GDP at the end of the fourth quarter from the level without the President's proposal.




Fourth-quarter to fourth-quarter growth rates are higher by 1.0, 0.8 and 0.0 percentage points for 2003, 2004 and 2005, respectively.