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STATE OF THE U.S. ECONOMY: WHY HAVE ECONOMIC GROWTH AND JOB CREATION REMAINED WEAK, AND WHAT SHOULD CONGRESS DO TO BOOST THEM?

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

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STATE OF THE U.S. ECONOMY: WHY HAVE ECONOMIC GROWTH AND JOB CREATION REMAINED WEAK, AND WHAT SHOULD CONGRESS DO TO BOOST THEM?

THURSDAY, FEBRUARY 28, 2013

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 9:59 a.m. in Room 216 of the Hart Senate Office Building, the Honorable Kevin Brady, Chairman, presiding.

Representatives present: Brady, Campbell, Duffy, Amash, Paulsen, Hanna, Maloney, Cummings, and Delaney.

Senators present: Klobuchar, Murphy, Heinrich, Coats, and Lee.

Staff present: Conor Carroll, Gail Cohen, Christina Forsberg, Connie Foster, Colleen Healy, Patrick Miller, Robert O'Quinn, Jeff Schlagenhauf, and Annabelle Tamerjan.

OPENING STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Chairman Brady. Good morning, everyone. I would like to call to order the first meeting of the Joint Economic Committee for the 113th Congress.

The Employment Act of 1946 established the Joint Economic Committee to analyze economic issues and make policy recommendations to Congress. As the 37th Chairman of the Committee, I want to congratulate Senator Amy Klobuchar on becoming Vice Chair, and welcome both new and returning Members to the Committee.

I would like to introduce our new Members: Representative Erik Paulsen of Minnesota, Representative Richard Hanna of New York, Senator Roger Wicker of Mississippi, Senator Christopher Murphy of Connecticut, Senator Martin Heinrich of New Mexico, and Representative John Delaney of Maryland.

While the United States confronts many problems, our most vexing economic challenge is the growth gap—and how we close it. The growth gap between this economic recovery and other recoveries is significant and intensifies our federal spending and debt problems.

The growth gap has two interrelated aspects:

First, by objective economic measures the recovery that began in June 2009 remains the weakest among recoveries since World War II.

Second, according to many economists, our economy's potential to grow over time has slowed. If true, the average rates of growth and private job creation during this recovery of 2.1 percent annually and 175,000 new jobs per month, respectively, are about as good as our economy will ever perform in the future. And that is unacceptable.

Therefore, it is appropriate that the first hearing of this Committee should address this growth gap. Why have economic growth and job creation remained weak? And what should Congress do to boost them?

The anemic nature of the current recovery is indisputable.

During the current recovery, real GDP increased by 7.5 percent in 3½ years. By contrast, average real GDP growth during the same period in all the post-war recoveries was 17.5 percent. Today's recovery is less than half as strong as the average.

Real GDP would have to grow at an annual rate of 5.5 percent in each of the next four years merely to catch up with an average recovery by the end of President Obama's second term. That would be slightly higher than the 5.4 percent annual rate that President Reagan achieved during the first three-and-a-half years of the Reagan recovery.

Private payroll employment—that is, jobs along Main Street—have increased by only 5.7 percent since its cycle low. Had this recovery been merely average, private payroll employment would have increased by 9.4 percent. The growth gap means the United States should have 3.9 million more private jobs today than it does.

Equally troubling is mounting evidence that the annual growth rate for potential real GDP in the future has fallen dramatically. In its most recent "Budget and Economic Outlook," the Congressional Budget Office cut its estimate of the potential real GDP growth rate to 2.3 percent, one percentage point below its average since 1950.

One percentage point may not sound like much. However, the real economy doubles in 22 years at a 3.3 percent growth rate. But at that lower, smaller rate, it takes 31.9 years to double, almost a decade longer.

The prospect of a "new normal" for America's economy in which our future economic growth permanently slows by one-third should be a red flag for all Americans.

During this Congress, the Committee will, through hearings and research, investigate the growth gap and how to close it. No doubt some of the growth gap may be due to demographic factors that are not so easily amenable to economic policy; however, even a cursory review of recent history strongly suggests that economic and fiscal policies have played the dominant role.

To understand how these policies affect performance, let us compare the generally pro-growth policies and the superior performance of the U.S. economy during the 1980s and 1990s with the generally slow growth policies and the lackluster performance during the last decade.

During the Great Moderation under both Republican and Democratic Presidents and Congresses and Republican, Democratic, and split control, the Federal Government generally pursued pro-growth economic policies and achieved outstanding results:

The size of the Federal Government, as measured by federal spending, gradually shrank relative to the size of the economy.

Marginal income tax rates fell. Policymakers focused on reducing the after-tax cost of capital for new business investment, and jobs grew.

Monetary policy became increasingly rules-based and predictable. Ignoring the employment half of its dual mandate, the Federal Reserve focused on price stability.

The regulatory burden on businesses and households declined.

And the United States led the world in liberalizing international trade and investment.

Beginning in 2001 under both Republican and Democratic Presidents and Congresses with Republican, Democratic, and split control, the Federal Government reversed course—in large part due to the terrorist attacks of 9/11—and the results have been disappointing:

The size of the Federal Government has grown substantially relative to the size of the economy, soaring to 25.2 percent of GDP and remaining elevated at an estimated 22.2 percent of GDP during the current fiscal year.

Marginal income tax rates were first decreased, then increased. In recent years, policymakers have primarily focused on the "fairness" of the tax system instead of its effects on growth.

Monetary policy has become discretionary once again. The Federal Reserve has justified its extraordinary actions based upon the employment half of its dual mandate.

The regulatory burdens on businesses and households has increased, generating uncertainty and inhibiting new business investment.

The United States has fallen behind its major trading partners in liberalizing international trade and investment.

Today is the perfect time to focus on the growth gap and what we should do about it. Given the historical and legal relationship between the Joint Economic Committee and the Council of Economic Advisers, it is appropriate that two of the most distinguished former Chairmen, Dr. Michael Boskin and Dr. Austan Goolsbee, are with us today as witnesses.

With that, I look forward to their testimony.

I recognize Vice Chairman Klobuchar for her comments.

[The prepared statement of Chairman Brady appears in the Submissions for the Record on page 36.]

[Chart titled "5.5% Growth Rate Needed Over Next 4 Years" appears in the Submissions for the Record on page 38.]

[Chart titled "How Does the Obama Jobs Recovery Stack Up?" appears in the Submissions for the Record on page 39.]

[Chart titled "Obama Recovery Dead Last for Growth" appears in the Submissions for the Record on page 40.]

OPENING STATEMENT OF HON. AMY KLOBUCHAR, VICE CHAIR, A U.S. SENATOR FROM MINNESOTA

Vice Chair Klobuchar. Thank you very much, Chairman Brady. It is an honor to be here in my first meeting as the Vice Chair of the Joint Economic Committee, and joined by many great colleagues from both the House and the Senate.

I look forward to working as a committee on some very good discussions and hopefully solutions to the budget and the economic problems facing our country.

I also want to thank our two witnesses, Dr. Boskin and Dr. Goolsbee. It is a great way to start this hearing with both of you having been former Chairmen of the Council of Economic Advisers.

We are gathered here at a time, as we know, when Congress' energy is focused on the Sequestration and the solutions to that. While that is not the focus of today's hearing, in many ways it's a good starting point for our discussion, not just because of its economic consequences but because it underscores the critical need for thoughtful, balanced, bipartisan policies that address our debt challenges without undermining growth.

My hope for today is that we can explore some of the bigger picture ideas for moving our economy forward, while discussing specific policies for strengthening the fundamentals, the core economic engines like entrepreneurship and innovation.

As we examine the current economic landscape, I think it is important to remember where we were just a few years ago. I sat through many hearings in this very room as we would hear the unemployment numbers, as we would hear from economists the difficult situation our country was in.

I think back to the first half of 2009 when our country was losing jobs at a rate of nearly 700,000 a month. That is literally equal to the entire population of Vermont.

Four years later, we are adding jobs. Not as many as we would like, but we have still seen 35 straight months of private-sector job growth. In that time, more than 6 million private-sector jobs have been created.

We have also seen promising signs of growth recently in critical industries like housing. Take the January numbers for new-home sales, they hit their highest rate in 4½ years, up nearly 16 percent compared to December.

Exporting has been another bright spot, with a total value of American exports reaching a record of $2.2 trillion last year.

I personally spent last week in 30-below-windchill weather around Minnesota visiting 30 different businesses, saw warehouses full of big crates that said "ship to China," and saw first-hand in our State where we are down to 5.5 percent unemployment what we are seeing with this kind of private-sector job growth, which is based so much on exports in our State, as well as a skilled workforce.

These are positive signs, but it is clear that there is so much more to be done. There are still more than 12 million Americans out of work, and there is no question that we have much more work to do.

Our focus needs to be on policies that spark job creation in the short-term, while laying the groundwork for prosperity in the long term. Because if we've learned anything from the economic turmoil of the last few years, it's that America can no longer just afford to be a country that churns money. Our financial industry is important, but it cannot be the basis of our economy.

We need to be a country that makes stuff, that invents things, that exports to the world. We need to be working to bring our country back to the brass tacks of innovation and entrepreneurship.

I again mention that I come from a State—I will try not, Chairman Brady, to mention my State too much if you don't mention Texas too much—but my State brought the world everything from the Pacemaker to the Post-It Note. We're second per capita for Fortune 500 companies. So I have a model that I look at when I look at how we were able to keep our head above water during this downturn.

And the model is really about innovation and exports. But this just isn't a Minnesota story, it's an American story. I believe that innovation is the engine that has kept our country moving forward since its earlier days.

So the things I think we need to focus on with this Committee, as we go forward, and working with Chairman Brady, and I hope we can be as bipartisan as possible—we're going to have different views, but as long as we get the right information from our witnesses I think we can come together on a number of hearings.

First of all, our debt. We need to bring our debt down in a balanced way. I personally think that there were some very good things coming out of the Simpson-Bowles Commission and the work that is being done by many on that balanced approach to bringing the debt down. I don't think we can put our heads in the sand, and certainly not when we're facing Sequestration.

Secondly, education. I think we should double our number of STEM schools. I think there is so much more that we can do to get our kids to get into science, engineering, technology, and math, with a better focus on these two-year degrees.

We have so many companies right now in our State that are looking for welders, and tool-and-die, and these are jobs that are there right now that are going unfilled because we have failed to train students in those areas where we have jobs that are good-paying jobs.

Exports, I mentioned. The President's goal of doubling the number of exports within this five-year period is attainable.

Regulations. Looking at keeping very important safety regulations in place, but going industry by industry and saying what can we do to make things work better so we can compete on an international basis.

Reforming our Tax Code so it provides greater clarity and consistency, and doing something about immigration reform which I think is very doable given the bipartisan work that's going on in the United States Senate.

I am excited about the coming year on the Joint Economic Committee and working with Chairman Brady and the rest of my colleagues. I look forward to this hearing.

Thank you, very much, Mr. Chairman.

Chairman Brady. Thank you, Vice Chairman.

As this time I would like to welcome and introduce our distinguished witnesses for today's hearing.

Dr. Michael Boskin is a Senior Fellow at the Hoover Institution and the T.M. Friedman Professor of Economics at Stanford. Previously Dr. Boskin served as Chairman of the President's Council

of Economic Advisers from 1989 to 1993, at which point the Independent Council for Excellence in Government rated the CEA as one of the five most respected agencies in the Federal Government.

Also, Dr. Boskin chaired the highly influential blue ribbon Commission on Consumer Price Index, whose report has transformed the way government statistical agencies around the world measure inflation, GDP, and productivity.

Dr. Boskin is author of more than 150 books and articles and is internationally recognized for his research, and has received the Adam Smith Prize for outstanding contributions to economics in 1998.

Dr. Boskin received his Bachelor's, Masters, and Ph.D. at California-Berkeley.

Next I would like to introduce The Honorable Austan Goolsbee. He is currently the Robert P. Gwinn Professor of Economics at the University of Chicago, the Booth School of Business.

Previously he served on the Council of Economic Advisers from 2009 to 2011, and led it as Chairman from September 2010 to August 2011. He writes monthly for The Wall Street Journal, and is a contributor and respected economic analyst for ABC News.

Dr. Goolsbee has also spent time as a Special Consultant for Internet Policy for the Antitrust Division of the Department of Justice, and was the lead editor for the Journal of Law and Economics for several years.

Dr. Goolsbee earned his Bachelor's and Master's Degrees in Economics from Yale University, and graduated with a Doctorate in Economics from the Massachusetts Institute of Technology.

Well clearly we have highly respected witnesses who we hope will bring insight. In reading your testimony previously, there is an awful lot of wisdom to be tapped today as we look at these issues.

So, Professor Boskin, Professor Goolsbee, thank you for your willingness to come before the Committee. We look forward to hearing your testimony and expert opinion.

Dr. Boskin, you are recognized for five minutes for your statement.

STATEMENT OF HON. MICHAEL BOSKIN, FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS, SENIOR FELLOW AT THE HOOVER INSTITUTION AND THE T.M. FRIEDMAN PROFESSOR OF ECONOMICS AT STANFORD UNIVERSITY, STANFORD, CA

Dr. Boskin. Thank you, Chairman Brady, Vice Chair Klobuchar, Distinguished Members of the Committee:

I have had the privilege of testifying before this Committee and working with it since the late 1970s when Senator Bentsen, and a remarkable bipartisan effort of 19 of 20 Members brought the supply side of the economy to the attention of Congress, amid the concerns there, in addition to the demand side. I obviously testified often in my four years as Bush, Senior's CEA Chairman when we were cleaning up two financial crises—the Savings and Loans and the Money Center Banks being insolvent. We had the first Iraq War, an oil shock, and a recession. So, not totally dissimilar to, although not as large a scale, as what we went through recently.

Obviously we had a horrific recession following the collapse of the housing market and the bursting of the housing bubble and the financial crisis. The recovery, unfortunately, has been anemic.

Compared to previous recoveries from deep recessions, GDP is growing at about 40 percent as rapidly, and employment only at 20 percent as rapidly. This long period of sub-par growth is as damaging to lost incomes and employment opportunities and skills as the deep and severe recession.

The modestly good news is, despite the fact the economy has basically been flat lately and most people expect this quarter to be only slightly positive, most forecasters expect the economy to pick up a little later this year and into next.

The Administration is particularly at the high end of that forecast, as it has been for some time. Hopefully they are right, but the Blue Chip is looking at 2.0 percent or a little higher growth this year heading toward 3 percent next. That would still be way below what the economy should be doing recovering from such a deep recession.

There are many, many risks the economy faces, from problems in Europe, to fiscal instability, to geopolitical issues, Iranian oil for example, continued deleveraging of the private sector, additional regulation raising costs and uncertainty that has yet to be written and enforced and so on. All of those—and the uncertainty about the Fed's exit from its monetary policy.

But there are a few good signs:

The fiscal drag of state and local governments from their tax hikes and spending cuts has probably peaked. The technology revolution in fracking is bringing energy costs down in the United States, and is promoting jobs along a wide array of our states.

Housing seems to be rebounding, and there's lots of cash sitting on the sidelines on household and corporate balance sheets waiting for an improved economic environment and an improved policy environment.

I believe that the early policies, the early Fed actions, the automatic stabilizers in the Tax Code, and making capital available to the banks, as poorly as it was done, was essential to preventing the recession being even worse. But much of the policy since then has not been nearly as effective as it could have been.

I detail that in my testimony, but in my own view the temporary spending increases, inframarginal tax cuts, the attempted social reengineering of wide swaths of the economy, from energy to health care to financial services, whatever their intrinsic benefits and costs, created a lot of uncertainty, delayed investment, and hiring.

So I think there's lots of reasons to believe that we have a different course of action as likely required now. In my opinion, it starts with a strong, credible commitment to serious fiscal consolidation, phased in gradually as the economy recovers; difficult to reverse absent a major emergency such as war or recession. That means it's got to be permanent and structural and likely requires toughened budget rules, process rules on spending and debt.

Pro-growth tax reform, lower rates on a broader base, which almost all economists agree is desirable, would be an important complement to that effort.

In the long run, we need to get entitlement cost growth under control in a manner that strengthens and preserves our key entitlement programs, but prevents them from bankrupting the rest of the private economy and the rest of the government.

Simply put, we are going to have too many people collecting too large of benefits—they're not all that generous at the bottom, but we should be trimming them at the top. And we should be slowing their real increase per-beneficiary through a variety of structural reforms.

I have calculated that the harm from allowing the projected debt to grow—we hear it is unsustainable. That's too antiseptic a term. It's dangerous. It really would lead, by all the basic studies that have been done of this, to a generation of lost income for our children and grandchildren on the order of 20 to 30 percent lower than it might have been. So we need to get the debt/GDP curve heading down in the near future as the economy recovers, and continuously.

I think that there should be, therefore, in addition to those two things—medium-term fiscal consolidation and tax reform—long-run entitlement reforms that minimize work and saving disincentives while reducing subsidies to the well-off.

Budget reform. Making programs more effective. Vice Chair Klobuchar pointed to some of these issues about jobs going vacant for lack of training. We have 46 job-training programs in the Federal Government. President Obama added another one for green energy jobs. It didn't work very well. The Labor Department's Inspector General said it should be shut down.

Most of those programs don't even have metrics. We need to take those 46 programs, eliminate the bad ones, consolidate the hopeful ones, modernize them, and get people trained for real jobs. That's something Republicans and Democrats should agree to. It's conservative and liberal. It will help more people at lower cost.

There are many examples of that throughout the government. I would be happy to take questions on that.

In terms of monetary and fiscal policy, they need to be far more predictable and permanent, what I call Rules-based. Even if it's not following a specific, clear rule, it's working as if it is roughly doing so. And any time it deviates from it, there's clearly an emergency reason, and so on.

You could start by eliminating the endless use of temporary tax rules and new spending programs that leave everybody uncertain about whether they will be renewed. Now that gerryrigs all the incentives in the economy.

Of course in addition to that, the human capital policies, education as well as job training reform, sensible regulatory reform, and I might add trade liberalization, which I'm glad to see the President has begun starting to talk about in some dimensions, would be an important complement to strengthen growth. But the focus should be on medium-term fiscal consolidation primarily on the spending side as the economy recovers.

The research shows successful fiscal consolidations that do not cause recessions and succeed in consolidating the budget have $5 or $6 of spending cuts for every dollar of tax increase.

So an economically balanced fiscal consolidation is primarily on the spending side; it's not 50–50.

Thank you. I wish the Committee good luck and tremendous progress under the new Chair and Vice Chair, and I look forward to working with you and to hearing your questions.

[The prepared statement of Hon. Michael Boskin appears in the Submissions for the Record on page 41.]

Chairman Brady. Great. Thank you, Dr. Boskin.

Dr. Goolsbee.

STATEMENT OF HON. AUSTAN GOOLSBEE, FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS, THE ROBERT P. GWINN PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO, BOOTH SCHOOL OF BUSINESS, CHICAGO, IL

Dr. Goolsbee. Thank you, Chairman Brady and Vice Chair Klobuchar. It's a great honor, and I appreciate the invitation.

I think the central question that you have raised here today fits in the tradition of the Joint Economic Committee where they have had a long history of Democrats and Republicans working together, the House and the Senate working together, and I think there are a lot of things that Dr. Boskin and I can agree on, not the least of which is our dress code today.

[Laughter.]

We did not coordinate, but if the questioning gets difficult I'm simply going to try to look like I were him and maybe direct the questions away from myself.

The central question is: Why is the economy not growing faster after a deep recession?

Now before—and I think there are three primary reasons for that, but before I state those reasons I would just like to make one factual observation. Which is: This is not the weakest recovery in recent memory. This is not even the weakest recovery of the last two recoveries.

The 2001 recovery was substantially slower than this one. What is different about this one is that it is not V-Shaped in the way, as Professor Boskin points out in his testimony, it was after the deep recessions of 1975 and 1982.

And I think there are three reasons why that is.

The first is, this Recession came from the popping of a bubble, unlike the 1982 and 1975 recessions, and popping bubbles are much more difficult to escape from the grips of than are the others.

So in 1982, my dear friend and mentor, Paul Volcker, rose—the interest rates rose to over 20 percent on mortgages. Economic activity slowed dramatically. As interest rates came down, that pent-up demand could come right back. The fundamental necessity for a V-Shaped recovery is not having to do a lot of structural transformation of what the economy is doing, but being able to go back to what you were doing before.

There was a joke headline in The Onion Newspaper: "Furious Nation Demands New Bubble To Invest In To Restore Prosperity."

Let us not try to re-enact that Onion headline. So it is quite clear, looking at the data, as we highlighted in the 2011 Economic Report of the President when I was serving as the Chair, that the expansion of the 2000s was dramatically outsized in the contribution of housing construction and personal consumer spending as the key drivers of growth. It was way underweighted compared to

past recoveries and expansions in the U.S., and compared to other expansions around the world in business investment and export growth.

We must shift the economy away—we cannot go back to the building of residential construction and personal consumption spending faster than income growth as the two drivers of growth. Those were fueled by a bubble, and they aren't coming back in the way that they were then. So that has taken some time.

As to what that means for the job market, I think it's not a secret that the reason the—the performance of the job market is tied to how much faster growth is than productivity. Productivity of our workers grows about 2 percent a year. So any time growth gets above 2 percent in the economy, you have to hire workers or add hours to meet that kind of demand. And if growth remains in the 2 percent range or below, the job market is going to remain relatively stagnant.

Now as Professor Boskin said, the good news is that the forecasts are that growth would get back up in the 2.5 percent or higher range in the immediate term. I fear that the impact of the Sequester would cut a half to one percentage point off the growth rate, and that it would again put us back into the circumstance in which growth is not fast enough to shrink the unemployment rate; that instead of unemployment shrinking, unemployment would be rising again.

I think the second factor that has made this not a V-Shaped recovery is that we're overcoming the worst housing market really in U.S. history. If you look at the research of Ed Liemer or others, housing and construction are the most cyclical component of economy. They have a much outsized importance in accounting for the short-run business cycle.

So the normal coming out of a recession is at least a third related to new construction. We got over-built in the bubble with 6 million vacant homes. Construction fell close to nothing. It's quite understandable why the overall growth rate of the economy has not come back in the short run as rapidly as in past big recession because we couldn't go back to getting anything from construction.

The good news is that the long nightmare of housing in many, if not most, markets appears to have turned the corner. So we may start to get some contribution from that.

Third, the evidence is that financial crises and big deleveraging take a major toll on growth. The Economic Report of the President from this year compares the U.S. experience in its labor market to the experience in other countries that have had major financial crises, and actually the U.S. appears to be doing a fair bit better than average for that circumstance.

Now all of those are just to say it's not fast enough, but I think it is understandable why it wasn't V-Shaped, why it looks more like the 2001 recovery than it does the 1984 recovery.

Lastly, I would like to say two things that I believe the data do not suggest are predominantly to explain why growth has not been faster.

The first is, I do not believe the data supports the view that regulation or policy changes over the last three years are the predominant reason why growth has not been a V-Shaped recovery.

If you look at things like the accumulation of money on the balance sheet of corporations and a lack of willingness to invest, that pervades all the advanced economies of the world. That is happening in countries that did not pass a health plan, that have not had any changes of their regulatory regime. And so anybody who is arguing that that regulation is the driver has to explain why the pattern is consistent across these other countries.

Second, the way economists normally measure the impact of regulation on growth when they say, for example, that the 1977 Clean Air Act affected manufacturing, they compare counties where it applies strictly to counties where it doesn't. They compare those industries and companies that are affected to those that are not, by size, by sector, et cetera.

If you do that now, there is little evidence that those regulatory policies are the primary driver.

The second factor that I believe the evidence does not suggest is the cause is the short-run deficit. Most of the short-run deficit has been caused by the downturn, not caused the downturn.

And while I one hundred percent agree and have for a long time been an advocate of a rational, long-term fiscal consolidation, I think you need only look at the GDP evidence in the United States in the fourth quarter, or in Europe where they're engaged in dramatic austerity, to realize that there is a tension between trying to cut too much in the immediate term and the growth rate.

I think the normal channels by which fiscal contractions can be expansionary go through the interest rate; that you satisfy investors, make them more confident in the plan so the long-run interest rate comes down.

We are facing epochally low interest rates. We have bumped against the zero lower bound multiple times. It is hard for me to understand the mechanism by which fiscal contractions would be expansionary in this environment.

I believe that there are many things that we can agree on, whether on long-run fiscal consolidation, on investing in training and innovation as the keys to growth. I hope we do not do something that would be a mistake in the short run on a purpose that is something other than re-establishing a growth strategy.

Thank you.

[The prepared statement of Hon. Austan Goolsbee appears in the Submissions for the Record on page 59.]

Chairman Brady. Thank you, Dr. Goolsbee. Thank you both for the testimony.

Dr. Boskin, as we look at the growth gap, ways to close it, risks to our economy, and more importantly solutions, you mentioned just recently the generational damage by this high spending to GDP ratio, and about the need for fiscal consolidation.

Economists generally believe that federal spending should be capped and controlled relative to the size of the economy. The challenge is how best to do that.

I would like your advice. We have developed over the past year-and-a-half legislation called the MAP [Maximizing America's Prosperity] Act that addresses the spending caps. The difference from past efforts is that we used two slightly different, we think, smarter metrics to do that.

One is the numerator is a non-interest spending; that which is controlled by Congress, both discretionary and entitlement-type spending. And the goal clearly there is to be able to gradually reduce what we can reduce without adding pressure on us to push the Fed to keep interest rates politically low for—to mask that debt.

The second, the denominator is potential GDP, rather than estimated actual or a rolling average. The thought being, it's not as cyclical. Congresses can't spend as much in the good times, nor do they have to cut quite as much in the bad times.

As we go forward trying to find bipartisan solutions on fiscal consolidation, on gradually lowering the size of our government relative to the economy, are those metrics good ones to work off of?

Dr. Boskin. I think you are definitely headed in the right direction, Mr. Brady. I think that it is important that we allow the automatic stabilizers, for example, to work. I mentioned them, and Austan dwelled on them, as the major cause. I agree that quantitatively they are a large part of the deficit.

So that's important. I do believe there are two other things that are worth considering. One is that for good purposes or other we often wind up doing things that are like spending but don't count as spending. We regulate.

When the government says "put this on your car," and therefore the auto companies do it and they charge people higher prices for their car, that may even have a good benefit/cost ratio but it doesn't show up as part of taxes and spending. It's almost the same thing as the government spending the money, taxing and spending the money, and installing it.

So regulation is a substitute. And tax expenditures, of course, are a substitute for spending. So you would need to have some complementary way—legislation, or some safety valve—to prevent, that you could tighten if all of a sudden the spending cap started to bind and it started edging into regulation and tax expenditures.

The other is, when you look at spending there's this fundamental fact of arithmetic we can't get around; that the present discounted value of future taxes has to equal the presented discounted value of future spending plus the national debt. The government has to pay its bills now or later. A dollar of borrowing now means a dollar plus the rate of interest tomorrow has to be raised to pay off the interest.

So with that in mind, it is very, very important that the spending caps be reasonable, and a bind, and that there is some mechanism by which we do not, even with reasonable spending caps, start continuing to accumulate more debt as well.

So there is an issue whether you need something on the deficit and debt side simultaneously with spending. Spending minus taxes equals the surplus or deficit. So you need really to do two to control three, but I think the fundamental—you are at the fundamental core. The first thing we need to get under control is spending.

We can argue. I think we would both agree that that should be done gradually as the economy recovers in the short-run, but in the long run these projections, even if you shave them for optimistic assumptions, are really, really tremendously harmful to take the path of spending, as I indicated in my testimony, as the OMB

projects for the President's policies with reasonable assumptions, which includes the future projected growth of Medicare and Social Security, means that we are going to have a wide swath of the population paying marginal tax rates of 70 percent when we keep paying for it with higher payroll and income taxes, not just the very well off.

And it is hard to imagine in a generation from now that we can have a successful, dynamic, growing economy with a large fraction of Americans being a minority partner in their own labor.

So I think that you are really right that spending is the fundamental thing.

The other thing I might say is, you want to give some thought to the very long run about whether you would have a recalibration exercise, or think about how demographics interact with it. But you're basically in the right place.

Chairman Brady. Got it. Thank you, Dr. Boskin.

Vice Chair.

Vice Chair Klobuchar. Thank you very much, Mr. Chairman. Thank you, both.

I did see a few common threads in your testimony, and I just want to start with the elephant in the room and go through a few questions a little more quickly.

On Tuesday, Federal Reserve Chairman Ben Bernanke testified before the Senate Banking Committee, and he said, and this is a quote: "The Congress and the Administration should consider replacing the sharp, front-loaded spending cuts required by the Sequestration with policies that reduce the federal deficit more gradually in the near-term, but more substantially in the longer run. Such an approach could lessen the near-term fiscal headwinds facing the recovery while more effectively addressing the longer term imbalances in the federal budget."

I will start with you, Dr. Goolsbee. Do you agree with his statement?

Dr. Goolsbee. Yes.

Vice Chair Klobuchar. Very good. Dr. Boskin, if you could keep your statement shorter, I notice that you talked about a phased-in reduction. Do you think that there is a better way to do this than the Sequestration?

Dr. Boskin. I think there is a better way, but I do want to make sure we understand that this year the total effect on outlays is going to be between $40 and $45 billion because the budget authority gets spent over a couple of years. That is one-quarter of one percent of GDP. So it is very hard to believe that this year the Sequester would be a major macro economic event, whatever specific dislocations it had for some programs and people.

Vice Chair Klobuchar. And——

Dr. Boskin. Next year it starts adding up. So it would be better to have it shaped like this (indicating). There's no doubt. But it is very, very difficult to credibly do that when we are living in a world where every two months we have got a new set of negotiations about what it is going to be. So——

Vice Chair Klobuchar. I agree, and I think there are many——

Dr. Boskin [continuing]. So there's a big tradeoff.

Vice Chair Klobuchar [continuing]. There are many up here that would have liked to do a bigger thing at the end of the year, but we will proceed now and have those opportunities in the next few months. And there are many I know in the Senate and I know in the House that want to get this done.

I wanted to just follow up on one thing you talked about, Dr. Goolsbee, that I thought was interesting, and that is the number of businesses that have accumulated money right now that we would like them to invest in our country.

And part of it is the problems that Dr. Boskin has been getting at with the uncertainty, with changes all the time, and you, I thought rightly, noted this is not just our country that has this problem. And what I wanted to get at is how you think we can unleash this money and get it invested.

Dr. Goolsbee. Well, in my view the reason it is accumulating in the U.S. and in other countries is fear about the world economy of has a recovery taken hold. For all of the discussion of our growth rate being modest, at 2.5 percent that is about the fastest of all the advanced economies in the world, which is a sad state of affairs. It has been a tough—it's been a tough period.

So I think uncertainty about overall world economic growth. And second, fear over whether there will be another major financial crisis led by problems coming out of the European banking sector.

I think those two things hang over the investment decisions of big firms. And really we can only address that part through macro economic management and trying to persuade the Europeans to confront their problems.

I think on the micro policy side, investment tax incentives I think do have some impact in an environment like this on the decision of: If you're going to invest, where do you want to invest?

I think putting a focus on, in some of the sectors, getting skilled workers, and trained workers that are, in our language, complementary to the capital, is quite important. Because you have seen in some high-tech manufacturing and in others they have not been able to do that.

And the third, I think there is a confidence element that, as growth gets going you will see more pressure like what you have seen with Apple, and others, that investors go to the firms and say: Either use the money for investment, or pay out the money and we will use it for investment; but do not just sit on the money.

Vice Chair Klobuchar. Okay. I wanted to follow up on one thing you raised, the workforce issue. I was picturing myself telling these small business owners in Minnesota: You need some workers that are complementary to your capital.

[Laughter.]

I am not sure that would quite work. But I think it is right on in terms of trying to encourage our schools, from the high school level on to train workers. I think manufacturing is one of our big bright spots right now, but we simply do not have enough people going into welding, and tool-and-die, and we need more women doing it because we simply need more people doing it. And we are in a big effort in Minnesota to recruit more women into manufacturing for the floor because of these job openings.

And if you could just briefly, in just a minute here, Dr. Goolsbee, talk about your views on this and maybe in a second round I will ask Dr. Boskin about your ideas with consolidation.

Dr. Goolsbee. I absolutely agree with that statement, both of those statements: that manufacturing has been one of the bright spots. It is pretty clear, as I said in my testimony if you look at the data, the U.S. has got to shift to a more export-oriented growth model. And, that the biggest export market for the U.S. is in the manufacturing sector.

The most of what we export are manufactured goods. In those cases, there are—and especially in a State like Minnesota where the unemployment rate has gotten as low as it has—those issues of finding structural mismatch and addressing it are quite important.

And it behooves us now at a time when I still think cyclical unemployment is the dominant factor nationwide, but very soon as the unemployment rate comes down structural unemployment will be what remains. And we have already seen the weakest part of the job market being the drop-outs of the labor force, and a group of people that have been unemployed for a very long period; that these issues of training and skill are going to be forefront issues.

The thought that we are going to cut into investments like that I think is short-sighted.

Vice Chair Klobuchar. Okay. Thank you very much, both of you.

Chairman Brady. Thank you. Representative Hanna.

Representative Hanna. You touched on long-term structural unemployment. As regards Michael Spence's work that I'll clarify for you quickly where I am going, we have created in the past 20 years, the vast majority of jobs have been service jobs. A very small percentage have been science, technology, engineering, and math.

We know that we have income disparities that are growing. We also know that every job is not the same. We could have zero unemployment and still people could be struggling paying their bills.

What do you think is the severity, in a global sense, that are increasingly moving away from those things we need to invest in to increase our global competitiveness in terms of innovation, tradeable goods, and that type of thing? How big a factor do you think the unemployment rate that we are seeing right now that seems to be so intractable is a function of us not being as competitive and as skilled as we needed to be as a people? For both of you.

Dr. Boskin. Well I think it's a substantial part of our problem. It's both a short-term problem and a long-term problem I think. People are not getting jobs now. American firms list 3.5 million job vacancies, saying they do not have workers applying with the skills they need. They are not all computer programmers. As Vice Chair Klobuchar mentioned, welders, tool-and-die people, et cetera.

That is partly a problem of our K–12 education system, and partly a problem of the opportunities, private and governmental, to retrain yourself when you need to retrain.

As I mentioned earlier, we need to modernize these job training programs. Austan used the phrase "hate to see us cut investments in that," well I think we can get a lot better out of it for less money, and actually help people a lot more than we do now.

So I think that spending should not be the metric. The metric ought to be how many people get jobs at the end. So I think it is a serious problem. I think in the long term it is a larger problem. As Austan said, there is still sizeable cyclical unemployment. But as that comes down, hopefully in the next two or three years to closer to full employment, what remains will be primarily structural.

I also think there is a tendency in many firms, when they are hit with really rapid, sharp adjustments, that they make deeper cuts, including stuff that has accumulated they have not gotten around to, with all due respect, and therefore they tend to shed a lot—in recent times, they have shed a lot of labor, more than they might have in previous downturns for the same cyclical component. And they have pushed their remaining workers to retool and train and become more productive.

So I think all that is interactive. I think there is something major to it.

Dr. Goolsbee. I think it is a major issue. I do not think that—I think it is not appreciated that the U.S.'s competitiveness problem has not principally been on the productivity side or the quality of our workforce. We remain, really of all the major economies, the most productive workforce in the world. And we only got more productive during this Recession.

So I think the long-run competitiveness of the U.S. economy is pretty strong. I think we have gone through a heavy cyclical unemployment period, and I think what Professor Spence has highlighted, and it is something we all ought to think about, is there are a lot of different sectors and different jobs that in some sense have never faced foreign competition that have become tradeable goods. And that leads to a lot of tough adjustments, and we will have to—and we should make quality investments.

I think Professor Boskin's point is well taken: Let's do those things that will get people jobs and sustain them in the jobs. The advance of technology, however, let's not overly dreadfulize it, if that is a word, if they had said in 1920 how many phone lines would exist today, they would have said that is flat out impossible because every man, woman, and child in America would need to be a telephone operator.

The fact that there do not need to be telephone operators did not put everyone out of a job. Gradually, as we trained for other things, we got more skill and we just shifted into other sectors, greatly to our benefit, and greatly to our income. And there is no reason we could not do that again.

Representative Hanna. Thank you.

Chairman Brady. Thank you. Representative Cummings.

Representative Cummings. Thank you very much. It is good to see both of you today.

Dr. Goolsbee, in your testimony today you suggest that Congress could help the housing market recovery by, and you said, "facilitating refinancing for people unable to take advantage of low rates because they are underwater and by facilitating people to convert vacant homes into rental properties."

I found it interesting what you said about housing. I think housing sometimes has been put on the back burner, and for my con-

stituents it is a big, big deal because they have lost a lot of wealth with the Recession.

Could you explain the actual benefits to the economy of allowing borrowers to refinance their mortgages down to these historic low interest rates?

Dr. Goolsbee. Yes. You bet. And in the City of Chicago where I live, the impact of the housing downturn has been really devastating, and in a lot of cities in the United States, as well as a lot of suburban areas. This has weighed on growth in a quite substantial way.

The benefit of refinancing is pretty simple. As Professor Boskin discussed in the case of taxes, the most effect of tax cuts are those that are long-lived and permanent changes to people's income.

We have got epochally low rates. But if you are underwater in your mortgage, you cannot go refinance at the bank. So you are paying an interest rate that is well above what the market rates are. And this has been noted by Chairman Bernanke as an impediment to monetary policies' effectiveness in stimulating the economy.

If people could simply refinance at the market rates as they are now, it would be literally for the average homeowner thousands of dollars lower payments per year that would just go straight into their pocket. It would be the equivalent of a 30-year permanent tax cut for them of thousands of dollars a year. And that is pretty substantial.

Now you do need to subtract off. Right now they make a payment to somebody, and that somebody does something with it. So it is not just pure stimulus. But the incidence in the short run of spending the money for people that are massively liquidity constrained and really hurting, trying to figure out how to pay their bills each month, that tends to be higher than for the banks who are currently sitting on reserves and for the mortgage-holders.

So I think that that could have a positive impact.

Representative Cummings. You know you said something else that was very interesting—well, you said a lot that was very interesting—but you talked about this Sequestration possibly cutting a half to one percent of the growth rate. And Dr. Boskin projected the growth rate at being a certain amount, I think 2 percent, about.

Talk about that. Because, you know, the Democratic Steering and Policy Committee had a policy hearing the other day where Professor Stephen S. Fuller of George Mason University, who is I take it a top economist from what I hear, talked about this very subject. And he believes that even a month of Sequestration would be like creating, not a hole but a crater in our economy.

I just want to have your comments.

Dr. Goolsbee. Okay. I think Professor Boskin and I disagree a little bit on what the multiplier would be of this spending on the economy. If you take forecasters like Macro Advisers, or some of the other standard macro forecasters, they anticipate that the direct impact of the spending, as Professor Boskin said, is maybe 25 basis points, .2 of a point to .3 of a point.

And the question is what other spill-on effects does it have. I think that leads it up to be a fair bit higher than the .2 to .3 of

a point. But I don't think that this is as big, for example, as what the fiscal cliff would have been, which in my opinion would have driven us into a recession.

In my view, this will cut the growth rate, and will cut it by enough that we drop below the 2 percent, so actually there's a decent chance the unemployment rate starts to go back up again instead of starting to come back down, but that's where I would characterize it.

Dr. Boskin. I think, Mr. Cummings, that it would be—it would take quite a stretch to make this into a major macro economic event this year. I think it is literally about a quarter of a percentage point direct spending. Economists are not sure in an expansion, with a high debt ratio, with where that spending will be offset, whether the multiplier is slightly negative .6, 1.3. The incoming Obama Administration used 1.7 in the midst of a deep recession when all economists agreed they would be much higher.

So that would get, if you took that, which I believe is fulsome, but, you know, there is a range, let me—there is a range of disagreement among economists—that would get us up maybe to .4 percent.

So even at the most sort of Keynesian of what has been used in Washington recently, it is a minor macro economic event. It's not trivial with respect to some particular things. It is disproportionate to the military. Some people are going to get disrupted. There is no doubt about that. But in terms of the overall hit to the economy, my best judgment is it would be a quarter of a percent, or slightly less.

Representative Cummings. Thank you, Mr. Chairman.

Chairman Brady. Thank you. Representative Paulsen.

Representative Paulsen. Thank you, Mr. Chairman.

Well this is obviously a very extremely important hearing, because I do believe our economy has a long way to go to reach its full potential.

Mr. Boskin, you had mentioned—Dr. Boskin, you had mentioned that the current recovery is about 10 million jobs short. I agree with you overall that we need a strong, credible commitment to serious fiscal consolidation, as well as pro-growth tax reform to turn things around.

I am just really discouraged about even CBO recently announcing that unemployment is expected to remain at about 7.5 percent all the way through 2014, which would be the sixth consecutive year we have had that type of a situation and the longest period in about 70 years.

So I guess my overall worry there is that this is being accepted as the new normal. It is being accepted by Congress. It is being accepted by elected officials. It is even being accepted by employers back in my District that understand that this is what is going to happen now. And I am worried about that, because we clearly do have a growth gap that needs to be addressed.

And Dr. Goolsbee mentioned bubbles. I suppose you can look back at the 1980s and see the S&L bubble, the 1990s, the dot.com bubble, and some would say the housing bubble and the mortgage-backed securities bubble of the 2000s. And now I sort of sense some would argue we are in a federal spending bubble.

Let me just ask you this, Dr. Boskin. At our current trajectory of spending right now, at what point do you expect investors would begin to lose confidence in the ability of the United States Government to back up our debt, to back up our debt?

Dr. Boskin. Mr. Paulsen, you are on to something extremely important. Just last week there was a major paper presented by a former Federal Reserve Governor and three other distinguished macro economists at the Fed, and they concluded that when the debt/GDP ratio, in looking at a variety of historical cases, gets to 80 percent, and in our net debt, leaving out Social Security, previously accumulated Social Security surplus, whatever we want to make of that, we are a little below that. Our gross debt is well over it. That you run increasing risk of a sudden, abrupt loss of confidence and a dramatic risk in interest rates that requires such a wrenching change in the budget position to become sustainable that you run into these long, depressed growth episodes.

That is by former Fed Member Rick Mishkin and three other prominent macro economists. So there is a serious risk. The only honest answer is, we cannot be sure. But if you are heading toward an iceberg, you ought to change course. You ought not see well how close can I get before I make a sharp turn?

So it seems to me we need to start getting the spending curve bending down, and we need to get the debt/GDP ratio not only stabilized but heading back down to a safety zone at 50 percent of GDP or something over the longer term.

Representative Paulsen. Let me ask you this, too, because you just mentioned interest rates and the growing cost of interest rates to the Federal Government as a part of our budget.

As interest rates normalize—at some point they are going to normalize—how much will these payments increase as a part of our national debt? And what are the tradeoffs as a larger share of revenues that now have to go to actually pay off interest?

Dr. Boskin. Well, that is another important point—I don't mean to disrupt Austan's opportunity to answer; I'll give it to him in a second—CBO projects that the interest costs over the next decade will almost quadruple from somewhat over $200 billion to between $800 and $900 billion a year, both from the higher debt and from higher interest rates.

That does not include—that does not envision one of these abrupt loss of confidence episodes in the meantime, which is possible. It is far from certain, but possible.

So the interest payments are going to be crowding out other outlays. They are going to be crowding out other activity. Higher interest rates will eventually start to crowd out investment, and we need that investment to generate jobs and increases in wages.

So it is a serious problem. I think that we have had an unusual period where the Fed, for some good reasons some not, and I have been very clear that the only grade I can give them so far is an "incomplete" because we do not know how they are going to exit from this and what is going to happen. I was a fan of the early policies. I have not been—I thought there were diminishing returns—not been a fan lately. But they basically replaced the credit markets with themselves, basically deciding to keep interest rates close to zero.

And that has enabled the budget to look better than it was. That is not why they did it, but as a byproduct it is going to make the budget look better than it was. So if we kind of normalize the budget for that, looking at what it would look like at closer to full employment, tax revenues would be well above their historic average of GDP at normal employment, for example, and their spending would come down a little bit on things like unemployment insurance and so on.

So if we looked at that, interest is going to become a big issue. And of course it is increasingly leaving the country. It is a sizeable fraction, roughly half, slightly over half, is now held abroad by foreign central banks, and pension funds, and insurance companies, and so on.

So it is a big problem, and that is an extra reason we need to get the debt down. But the effect on interest rates will primarily reflect what the budget position is, number one—is it a surplus; as Mr. Brady mentioned, a primary surplus if we exclude interest—if we get to a primary balance and a surplus, that should take a lot of pressure off the risk of interest rates rising a lot.

Chairman Brady. All right, thank you. Representative Delaney.

Representative Delaney. Thank you, Mr. Chairman. And I want to thank you and the Vice Chair for your opening comments, which as someone who is new to Congress I found overly constructive and bipartisan, and I appreciate that very much. Thank you for having me on the Committee.

Dr. Boskin, I thought the last point you made was actually a very good point, because I think the point that is often overlooked when we talk about our deficit situation is the fact that we do not borrow from ourselves. Other countries, like Japan, that have been able to maintain very high debts effectively borrow from themselves and they do not have market forces that affect their interest rates. In other words, it is not just controlled by ourselves. Which is really why it is so important for us to deal with this now while interest rates are low, and while we have the flexibility to reform some of our entitlement programs in a smarter way than what will ultimately or inevitably happen if we do not deal with this now.

So I agree with the comments. But I wanted to actually shift my question to tie into some of the comments that actually Mr. Hanna made, which I thought was a very good point about U.S. competitiveness.

Because it seems to me that that is one of the central issues that this country faces. And it really started probably 20 or 30 years ago when we entered a global, and technology-enabled world which really did change the face of employment in this country.

And while we talk a lot about tax policy, and we talk a lot about the size of government, I worry that we do not talk enough about what the future competitive situation of this country is. Because even though we have seen cyclical employment trends, the trends around the standard of living of the average American have been very consistent. They have been down.

And that seems to me to correlate directly to our competitiveness. Because if you are competitive, you actually create jobs that have a decent standard of living. And if you are not competitive,

you continue to create jobs, to the extent you create them, that have a deteriorating standard of living.

When I think about our competitive situation, it seems to me reforming immigration. You know, there are 7 billion people in the world, 6 billion still wake up and largely want to come here. It is a huge advantage we have as a country.

Having a national energy policy, or the lack of a national energy policy, which we do not seem to have as a country. Not doing the things in education. There has never been a stronger correlation than there is now between having a good education and getting a job. Not investing in our infrastructure. And not creating enough avenues for the significant amount of private capital that is accumulating to actually invest in our economy and shoulder some of the burden that government has effectively had to shoulder.

I worry about these things as they relate to our long-term competitiveness. And my question to you two gentlemen, and field it as you see fit, is:

How do we think about the role of government in light of what I think is a changing economic landscape for the country? In other words, a landscape that is defined by globalization and technology? How do we think about the role of government to address these things to make us more competitive so that we actually can reverse the employment trends? And again, the employment trend I am most concerned about is what has happened to the standard of living of the average American.

Dr. Boskin. Do you want to start? I've had the last few, but I'll be happy to go.

Dr. Goolsbee. My grandmother lived in Waco, Texas, and she used to say to me whenever I would complain about anything, she would say: You know, 80 percent of the world really does not care about your problems; and the other 20 percent are glad.

And if you start—if you were thinking, how long will we need to wait before the government solves our private-sector competitiveness problem, I think the answer is: Forever. The government is not going to—if you were waiting for the Fed to fix it, or the government to fix it, or anyone else, you would do best to remember that the vast majority of what happens for the competitiveness of U.S. enterprises has nothing to do with the government. Policy is only setting the framework that that is operating in.

In my view, the government has for many decades played an important function through direct and indirect support of research development innovation in ways that have been quite fundamental to the growth of U.S. industries.

The economic infrastructure of the country is quite important. You can disagree about individual job training programs, but there is not any question in my mind that overall federal support through financial aid and through training have been crucial in keeping the workforce the most productive in the world. And we do also need to have things like a national energy policy. The potential drop of energy costs could be a great boon to U.S. manufacturing. So it behooves us to figure out a way to take advantage of the new discoveries, while being mindful that we have got to do that in a way that is safe.

But I think that it is in those types of broad-based things that the government can play a more important role, rather than in the directly making companies more competitive.

Dr. Boskin. I think Austan and I generically agree that this is primarily something that the private sector primarily does this and the government plays a supporting role and directly does a few things we wouldn't expect the private economy to be able to do well.

Pre-competitive research and development, to take the extreme case, basic physics, individual firms cannot appropriate the benefits from that so they are not going to do it, so it has to get done through NSF and things of that sort.

But that needs to stop short of outright industrial policy where we are subsidizing specific firms, by the way which means you are giving a competitive disadvantage for their competitors.

Education is important. The key, however—the key difference between Austan and I, I would suspect, is we would draw the—I would draw the line a little shorter than he would. He would have a little larger government; I would be very concerned about the effectiveness—he would surely be concerned about the effectiveness, but I would be concerned as the larger it got the less effective it got.

And importantly, if the government is playing this role, the larger it gets it does crowd out the private sector. So if a combined state, local, and federal government is 50 percent of GDP versus 40 percent versus 30 percent, the larger it gets, on balance the more difficult time the rest of the economy will have because it has got to pay taxes and do other things to support that size of the government which provides disincentives to work, and save, and invest.

Chairman Brady. Thank you, Dr. Boskin. I don't mean to interrupt, but with votes pending I want to make sure we get as many people as possible.

Senator Coats.

Senator Coats. Thank you, Mr. Chairman.

I ask my staff each day to prioritize my memos, and I am going to work off this first one. Despite Tuesday's loss to Minnesota, the Hoosiers still control their own—oh.

[Laughter.]

Vice Chair Klobuchar. Thank you for bringing up that fact, Senator Coats. We appreciate that.

[Laughter.]

Senator Coats. That is my first priority——

Vice Chair Klobuchar. Since they lost to our team.

Senator Coats. Let me get to my second——

Dr. Boskin. I never thought I would be from a football powerhouse, either.

[Laughter.]

Senator Coats. The Cubs still stink.

[Laughter.]

I say that as a lifetime, long-suffering Cubs fan. That is an area where Dr. Goolsbee and I have suffered greatly. Let me get to my questions. Dr. Boskin, I was interested in your comment here,

which I would like to go into a little more detail on, and I would like to get Dr. Goolsbee's response to this.

You said economically balanced is not 50–50 between spending and taxes. Simpson-Bowles came in with a Commission report about a 3-to-1 ratio spending over taxes. Yet the Administration continues to insist that any kind of long-term deal that will put us on the right track has to be 50–50.

What should that ratio be? You said it should not be 50–50. What do you think it should be?

And, Dr. Goolsbee, how would you respond to that?

Dr. Boskin. Well, I think the economic evidence, from looking at all the fiscal consolidations in the entire OECD since World War II, would suggest that the successful ones have been $5 or $6 of actual spending cuts, not hypothetical future ones but actual cuts that occurred, for every $1 of tax increases.

That does not mean that has to be exactly that. It could be a little bit smaller, a bit larger. The U.S. may have slightly different circumstances, but it suggests it is primarily on the spending side.

The evidence also from economics research suggests that tax hikes are much more likely to cause recessions than spending cuts. There are many, many studies that suggest that. There is a study by one of Austan's colleagues when he first joined the Council of Economic Advisers suggesting that what they would call the "output multiplier" is very high for tax increases. So tax increases can be very dangerous in the short-term.

So I think that the mix for economic reasons—there are many other considerations. People care about the size of government as a political and philosophical and a liberty issue. People care about the distribution of income and so on. But basically as a macro economic issue it should be overwhelmingly on the spending side, in the vicinity of 5-to-1.

Senator Coats. Dr. Goolsbee.

Dr. Goolsbee. I think two things on this.

First, the evidence that Professor Boskin is citing is based on a circumstance that is fundamentally different than the circumstance we are facing now.

Our long-run fiscal challenge is nothing more and nothing less than the population is aging, and the health care costs are rising. So that if you just advance forward the Baby Boom to their retirement with the existing policy that we have known about for 40 years, it implies the government's size will get bigger than it ever was before.

And so either you have got to cut those promises, or you have got to raise revenues higher than they have ever been before to cover them, or some balance. Those are fundamentally different than the experiments that are in this evidence.

In my view, Simpson-Bowles laid out what they said was 3-to-1, but that is counting saved interest payments. It is really about a 2-to-1 ratio. When the Administration is arguing about 50–50, I think it is best to also remember we have had one round that was all cuts and no revenue, and then one round that was all revenue and no cuts.

If you add all of these things together, so far we are at about the 2- to 3-to-1 ratio that was in Simpson-Bowles. That strikes me as

a perfectly appropriate starting point that we ought to balance these things against; so not on any one particular deal. But at the end of the day, if we do the $4.5 trillion of cuts over 10 years that Simpson-Bowles recommend, that the total would be 2-to-1, or 3-to-1 spending cuts to tax revenues seems totally appropriate.

Senator Coats. I have 35 seconds. Dr. Boskin, any follow-up to that?

Dr. Boskin. Yes. I think it is important to appreciate two things. Number one, this is not primarily an aging-of-the-population problem. The projected cost increase in Social Security and Medicare are primarily because of rising real benefits per beneficiary.

Demography is a very large minority partner, but we are making them more and more generous as they go along relative to the cost of living.

Now some people might say we ought to have those be proportionate to the size of the economy, but the original mission of Social Security, in FDR's words, was to provide a measure of security against poverty-ridden old age.

If I were to collect Social Security at the right time, I would be getting twice the poverty level just in my Social Security payments. So we cannot keep projecting—I would use "projecting," not "promises," I do not view 70 years from now as a promise; ask my students, or young children today, they think that Social Security will not be there, so it is a big increase if you actually provide something for them, not a cut.

So I think that we have to get these programs under control. With respect to the Simpson-Bowles, I think there are many good things in there. I supported a large fraction of them. They did not deal with health care costs, and that is a big issue, and that is a large—as the President and others have said—a large driver of future debt.

Senator Coats. Thank you. Thank you, Mr. Chairman.

Chairman Brady. Thank you, Senator. Representative Maloney.

Representative Maloney. Thank you, Mr. Chairman. And I would like to commend you and compliment you on your new position, and Vice Chair Senator Klobuchar.

I also would like very much to welcome a new Member on the Democratic side, Mr. Delaney, from the great State of Maryland, who has been a very successful businessman and will bring a tremendously important perspective to this Committee. And of course welcome to our two panelists, and thank you for your government service for our country.

Tomorrow, the real question before your government now is Sequestration that kicks in with an $85 billion cut. It is estimated that this will result in a loss of over 700,000 jobs.

Chairman Bernanke testified yesterday before the Financial Services Committee in the House of Representatives. And although we have been gaining jobs over 35 months of roughly 6.1 million in the private sector, 5.5 million of non-farm payrolls, but the government lost .6 million jobs. But he testified that the Sequestration was a problem not only—and I will quote him: Besides having an adverse effect on jobs and incomes but, he said, a slower recovery, which he says Sequestration will cause with our fragile economy, would lead to less actual deficit reduction.

Now the whole purpose of Sequestration is deficit reduction. He is testifying that it will slow that because of the impact on jobs and incomes.

There has been testimony today that the impact on GDP would be roughly a quarter of a percentage point, but the independent CBO estimates that it will contribute about .6 percentage point to a fiscal drag on the economic growth this year.

I would like to hear your comments in relation to what Chairman Bernanke was saying, that the idea of phasing it in over time, having targeted reductions, the Democratic minority keeps putting forward closing loopholes, let's not fire all these people that are paying their taxes and are a part of the economy, dredging more money back into the economy instead of having them on welfare and not able to produce and be part of the economy.

And this is turned down by the Republicans. But there was an article this week in one of the papers where Speaker Boehner was quoted as saying, in terms of the tax debate, because we all support tax restructuring, that he would take closing loopholes if given a lower rate for taxes.

But it seems to me that closing some of these tax loopholes—why we are giving tax breaks to companies that move overseas and take our jobs over there is beside me. If you are going to give a tax break, give it to someone who is providing a job here in America.

Also, the tax subsidies of 40 percent in some examples to really very successful oil companies that are making a lot of money. Why are we subsidizing a company that is making a lot of money?

It seems to me that closing these loopholes and lowering the deficit would be a better approach than closing loopholes and giving a lower tax break. So I would like Dr. Goolsbee's response to those two questions, and yours, Dr. Boskin, too.

Dr. Goolsbee. Okay, on the first I think I am more in the camp, as I outlined, of the Congressional Budget Office and the Macro Advisers that the impact of Sequestration would be half a point to as much as a full point off the growth rate. And I think that would be enough to set the labor market back, and might even start it deteriorating.

On the tax loophole point, I think what Professor Boskin said in his testimony, that there is a whole lot of spending that is done through the Tax Code, is correct. And so if you cut the loopholes, it is not accurate to think of that as tax increases. By that very logic, we should be viewing cutting of tax loopholes as spending cuts.

So I do not see that there is any problem with changing the form of the spending cuts to be in a more rational direction, and I hope that we would get it off of the next 6 to 12 months and into a period where the economy would be recovering more quickly.

Chairman Brady. Gentlemen, I am going to be tight on the five-minute limit for questions, just because a vote has been called. And so I would like, with your permission, to go to Representative Campbell, Representative Duffy, and Senator Lee, in that order.

Representative Campbell.

Representative Campbell. Thank you. And because votes are called I will not take the full five minutes. So I will just ask one question.

The title of this hearing is: Why has economic growth and job creation remained weak? And what should Congress do to boost them?

I would ask each of you, and I will start with Dr. Boskin, this House and Senate, we cannot do too many things at once; it is just kind of the way we are. So give me your number one thing that you would think we should do to boost job creation and economic growth, and one thing you would say we should avoid. Dr. Boskin?

Dr. Boskin. The thing I would avoid would be any major tax increase. The second thing—the first thing I would do would be to try to have a credible commitment to serious fiscal consolidation as the economy phased in. That would mean changing indexing formulas, altering structural features of programs not just cutting a few billion off of one program next year that could be reversed the next.

Representative Campbell. Fiscal consolidation? That's a new word.

Dr. Boskin. Primarily getting spending headed down as the economy recovers.

Representative Campbell. Okay.

Dr. Boskin. It's growth of spending heading down, spending to GDP ratio heading down.

Representative Campbell. Dr. Goolsbee.

Dr. Goolsbee. I guess I would say putting investment in the workforce is the most important thing in the short run. And I would say the thing to avoid would be anything that is going to have a significant negative impact on incomes and wellbeing of the broad middle class of the country over the next 6 to 12 months.

Representative Campbell. Okay, both of those are pretty broad. Investment in training? What——

Dr. Goolsbee. Sure.

Representative Campbell [continuing]. What is that?

Dr. Goolsbee. Quite specifically, federal R&D spending I think that we should not just not cut it, that we should increase it. I think investments in economically important infrastructure, which are not all roads and bridges but a lot of the shipping, container ports, and that type of infrastructure is important.

Representative Campbell. Okay. And then the thing you said we should avoid was what? Give me an example of that.

Dr. Goolsbee. Well tax increases on the middle class would be one.

Representative Campbell. Okay.

Dr. Goolsbee. Things that are depressing the wages of the middle class, or—I'll leave it at that. The biggest example would be things that would increase the taxes on the middle class. The stuff we are doing on the housing front can be thought of somewhat in that vein.

Representative Campbell. Thank you very much, Mr. Chairman. I will yield back so others have a chance.

Chairman Brady. Thank you, Mr. Campbell. Representative Duffy.

Representative Duffy. Thank you. I am concerned about the unemployment rate of our youth. I believe the number from those who are 16 to 19 years old have an unemployment rate of 23.5 per-

cent. Those who are 20 to 24 years old have an unemployment rate of 14 percent, much higher than the national average.

I would ask you both, with some quick answers, are you concerned about it? And what impact does that high unemployment rate have on the life skills that our kids learn at this very important age?

Dr. Boskin. You are exactly right. It is a major—even though it is limited to some subset of that group—it is a major problem. Not being in the workforce means they are not acquiring those skills, so they are relatively being left behind. What skills they have learned from high school or part-time jobs or jobs earlier is deteriorating.

So I think it is very important that we have a more robust economy. We have talked. We agree on some things and disagree on others about how to create that in the short run, but I also think we need to dramatically improve our K–12 education system.

I think injecting competition into it is one. It's not the only, but it is one thing that could be done to improve it so that they wind up at the beginning of their careers with skills that are better matched, number one.

And number two, we reform these programs that we have spent a lot of money on so that they actually provide jobs, not just spend a lot of money.

Representative Duffy. Thank you. Dr. Goolsbee.

Dr. Goolsbee. Sadly, and I have published on this subject that I am about to describe some work, the evidence suggests that the negative dynamic you are describing is persistent and damaging. That if you come out of school in a period in which it is hard to get a job, or you are forced to take a lower level job than you should based on your background, that that sticks with you partly because of less skill development, partly because you get tracked in a negative way.

So I think it is critically important. I think we have—the most important way to do that is to get the overall growth rate of the economy up. But I think that the youth unemployment is one of the weakest and scariest parts of the labor market.

Representative Duffy. And that age range, from 16 to 19, 20 to 24, are they the higher earners or the lower earners in our economy? They would be the lower earners, right?

Dr. Goolsbee. Well, yes and no. It depends where you are in the skill distribution. I was going to say for the 16 to 19, you have seen actually a big uptick as people could not get jobs and stay in school longer.

Representative Duffy. But you would agree that on average our younger individuals make less money?

Dr. Goolsbee. Oh, yes. Sure.

Representative Duffy. So if we want to improve the opportunity for the youth in our country to make sure they learn the skills that are necessary to be successful on a career track, can we grow more opportunity for them, create more jobs for them, if we would just raise the Minimum Wage?

Dr. Boskin. No. I think that the Minimum Wage has offsetting effects. It may raise the incomes of some, but it obviously will disemploy others and will tend to disemploy people with the lowest

skills. It is not very carefully targeted in this regard. So teenage children of rich people who are working in Minimum Wage jobs will get more, et cetera.

So it is a big concern, but I think that raising the Minimum Wage is not the most effective way to try to deal with this problem.

Representative Duffy. And, Dr. Goolsbee, you had talked about the growth of jobs. Will that help grow jobs if we raise the Minimum Wage for that sector of our economy?

Dr. Goolsbee. Well I think the most important word in what Professor Boskin just said is the tradeoff; that the Minimum Wage has tradeoffs.

There are some people that it would raise their wage and make it harder to get a job. There are others it would raise their income. And the question and the tradeoff is really how much do you think that affects the overall income and consuming power——

Representative Duffy. But my question is very specific, though. Will it grow jobs for the——

Dr. Goolsbee. It could. It depends, as I just said, it—if you believe that the total income is going to rise for low and middle income people, then that could grow jobs, yes, by increasing purchasing power.

Representative Duffy. So your position is that if we increase Minimum Wage, that means that more of our small businesses or manufacturers, the places that a lot of these youth work in, will have more opportunity and more jobs for the youth in our community? Is that your position, Dr. Goolsbee?

Dr. Goolsbee. Well, no, Congressman. My position is that the Minimum Wage does several things, not just one thing. But just looking at the one thing is the incorrect way to look at it.

Representative Duffy. But I am looking at the one thing with regard to job growth, and your position——

Dr. Goolsbee. As regards job growth, there are two factors. One is what is the direct impact on the wage of the people who can't get a job, on the people who are still employed, their income goes up, and what is the overall macro impact? And the macro impact may outweigh the direct impact.

Representative Duffy. So to invest in our workforce and to grow jobs, a good policy would be to increase the Minimum Wage to provide more opportunity for the youth in our community?

Dr. Goolsbee. It could, or it might not. It depends on what those values are.

Representative Duffy. Whatever you——

Chairman Brady. We will be tight, if you don't mind, and we can continue this discussion. Thank you, Mr. Duffy.

As I recognize Senator Lee, let me—votes have started in the House, and I want to thank Dr. Goolsbee and Dr. Boskin for being here today. It's been very helpful. And as Senator Lee closes out discussion, I want to turn the rest of the hearing over to the Vice Chair, and thank you very much.

Vice Chair Klobuchar [presiding]. Thank you very much, Mr. Chair. We had great attendance at this first hearing of the year, and I thank you for your leadership.

Senator Lee. Thank you, Mr. Chairman, and thanks to both of you for joining us today.

Dr. Boskin, I wanted to talk to you a little bit about tax reform. There does seem to be a pretty broad bipartisan consensus that we need some kind of tax reform, especially some kind of Tax Code simplification.

It was in this committee just a few months ago that we had a gentleman who has a Ph.D. in the U.S. Tax Code system, and we asked him if he did his own taxes and he said, no, I don't.

And we asked why. And he said: Because there is no way I could possibly know whether I was correct. And I think that is indicative of how many Americans feel.

So for that and other reasons, I think there is a pretty broad consensus among Republicans and Democrats in both Houses of Congress that a simplified approach to the Tax Code would be better. We need some kind of tax reform.

There is not broad bipartisan consensus on what that ought to look like, at least in the sense that some are less inclined than others to say that we need a tax reform package that would yield more revenue when statically scored.

But I think most would agree that, as long as we are within the world of saying we are statically scoring something, if we can assume that we are going to be neutral, if we keep what we have got, maybe we would be better off reforming the Tax Code, simplifying it, and leaving it revenue neutral at least under a statically scored model.

And then at that point, some would suggest that that would stimulate economic growth, leaving us free then to see whether or to what extent it did lead to more revenue as a result of economic growth occurring in the wake of passage of that reform package. Would you tend to agree that that would be a good idea?

Dr. Boskin. Yes, I think it is an excellent idea as long as it is primarily of broadening the base and lowering the rates. I think that a tax reform that raised tax rates would be a bad tax reform.

So broadening the base and lowering the rates. We have not talked much about corporate tax reform, or about small business here, but so many successful small businesses, 3 percent of the businesses but half of small business income, some of it is passed through but some of it is what we normally think of as small business, pay out on the personal form. So broader base, lower rates would be very good for their incentives.

And we have the highest corporate rate in the world, nominally, between federal and state taxes, about 39 percent, the highest in the OECD. The effective rate, when you account for deductions and exemptions and so on, is lower. It's in the high 20s. But it is out of line, but not as far out of line, as the statutory rate.

So I think that moving in this direction could be very good for the economy, both the short and long run, but it is—and I do believe that if it was accurately statically scored that at least over time it would raise more revenue than is likely being forecast in the models.

Senator Lee. Particularly if, as you suggest, we lower the rates and we broaden the base. Would that also tend to have the impact of stabilizing, or producing a less volatile revenue stream?

It is my understanding our income tax system brings in about 18.5 percent of GDP on average. We have peaks and valleys within

that. I think in 2011 we were in a valley of about 14.5 percent. At times we have gone just a little over 20 percent, but generally do not go higher than that.

Could lowering the rates and broadening the base produce a more stabile code?

Dr. Boskin. It very much would, because the—the steep progression, some say the rates are too high; I am not going to argue about the levels, but we have relative to the other OECD countries according to OECD the most progressive tax system. They have larger tax. They collect more with value-added taxes, but we have a more progressive tax system. It becomes more volatile.

The place to see it most is my home State of California where we have by far the most volatile. We have a very progressive income tax. And we get into this awkward situation, especially with our balanced budget requirements, which are sort of adhered to, we wind up having the revenue flow in. They spend that. They project more. Then the crisis hits. We rely heavily on capital gains and stock options across Silicon Valley. The revenues collapse. It is very hard to cut spending.

So we wind up trying to make the Tax Code more and more progressive, and we wind up not being able even to fund the basic benefits for people that are really hurting in California.

Senator Lee. It is a tough cycle.

Dr. Boskin. You're right.

Senator Lee. That is a tough cycle. That is why I ultimately tend to come to the conclusion that where there is not consensus on everything, we ought to look to where there is consensus. There does seem to be a certain amount of political consensus that we need tax reform in the form of simplification.

Maybe we could start out with something revenue neutral, one that is statically scored, and then see where it takes us. That would leave subsequent Congresses free to either plus-up or minus-down where they go from there.

If I can ask one more question, as my time is expiring?

Vice Chair Klobuchar. Of course. It looks like it is just the two of us here, Senator Lee, so please go ahead.

Senator Lee. Thank you, thank you, I appreciate that. Thank you, Madam Chair.

In your testimony, Dr. Boskin, you mentioned the need for permanent structural changes, not just a specific dollar cut, while discussing a credible commitment to deficit reduction. Can you speak to us briefly on the importance of maintaining our Nation's credibility in deficit reduction packages? And why it is that markets are not going to be satisfied in this regard with cuts? In other words, tell us why cuts just will not cut it anymore?

Dr. Boskin. Well it turns out that, if you look at the history of these budget negotiations, I have been involved in several when I was CEA Chair, for example, and advised on others, sometimes the cuts, "cuts," evaporate later. Now sometimes tax policies change also later, and that tends to happen less frequently.

There are a lot of frequent changes, but if you cut tax rates it becomes a much bigger battle than small changes in spending at the next appropriations hearing.

So I think what people want to see in financial markets, what people what to see about what the environment is going to be for investments that are paying off 5 and 7 and 10 years now. Austan mentioned infrastructure. A lot of that should be going on in the private sector.

Big investments in—he mentioned energy. We can be exporting natural gas. That is going to require firms investing ten billion dollars for an export terminal. To do that, they have to have some notion of what the taxes they are going to pay on that when they finally get that investment done and they are starting to export the stuff.

And so that is, to me, credible means that the rules have changed and they are harder to reverse than just a typical single appropriations bill next year if the makeup of Congress changes, and so on.

Senator Lee. Okay.

Dr. Boskin. So tax rules, indexing formula, retirement ages phased in over time, things of that sort. We have had a history in the past of those actually occurring, like from the 1983 Greenspan Commission and Social Security changes.

Senator Lee. These are the kinds of permanent structural reforms you are referring to——

Dr. Boskin. Yes.

Senator Lee [continuing]. As contrasted against something that just occurs in a CR or something.

Dr. Boskin. Yes. You just say we will cut $10 billion, and it may happen once, or it may not. And the following year it is up for debate again.

Senator Lee. Thank you, Dr. Boskin.

Thank you, Madam Chair.

Vice Chair Klobuchar. Thank you very much, Senator Lee.

I just had one last question. As we grapple with immigration reform in the Congress, and if you could just talk, each of you, a little bit about how you view this from an economic viewpoint for the country. There are many aspects of immigration reform, but one of the parts that I have been working on with Senator Hatch and I have a bill called I-Squared, along with Senator Rubio and Senator Coons, and what it does is basically makes it easier for students from other countries when they study at our universities, that they more easily access a green card. In fact, get a green card when they get an advanced degree in science, math, technology.

And then we also are doing more with the cap on the H1B visas. Senator Warner and Senator Moran have another bill called Start-Up 3.0, I think, that is about entrepreneurial visas. And if you could talk a little bit about how this fits in with the overall economy.

We have been focusing on job training, which is a major part of this. In fact, our bill adds $1,000 in fees supported by the Chamber for each of these H1B visas, and that money is going to go directly to STEM education to help train our students in these areas where we have openings right now.

I guess we will start with you, Dr. Boskin.

Dr. Boskin. I am a strong advocate of immigration reform, sensible immigration reform. Three key components of that would be

the green card provision you are talking about. It is silly that we have these great students that come from abroad to Stanford and Chicago, and the University of Minnesota, and then we send them home.

We make it hard for them to stay. They should be working here and helping us grow our economy. The H1B visas, again, we tend to focus a lot on the problems of people who are at the lower end of the income scale, as we should. That is a big concern. But we should not neglect the technology jobs and so on. Those are important. That is a place where the economy is growing and can continue to grow.

And then thirdly of course we need a sensible guest worker program. There are other aspects about making sure that we do have a border that is enforced and things of that sort, and these get very emotional. But I think it is the case that we have been refreshed numerous times by waves of immigration in our society.

One of the beautiful things about America is how diverse we are in many dimensions. And it seems to me if we are smart and we have an immigration policy that strengthens the opportunity for higher skilled people to stay here and improves the opportunities for people with lower skills, that it could do so again.

Also, finally I would say these problems of Social Security and Medicare, and the slowing growth of the labor force which Chairman Brady mentioned about potential GDP out there over the next 50 years, unless our birth rates change we are going to probably need to have some more immigration.

Vice Chair Klobuchar. And I appreciate those comments. One of my favorite statistics is that 30 percent of U.S. Nobel Laureates were born in other countries. So, you know, you go back in time and this has been a major part of our innovation in our country that has built America.

Dr. Goolsbee.

Dr. Goolsbee. Look, Senator, thank you for your support and leadership on this issue. We talked about this a lot when I was in the Administration, and we should keep talking about it now——

Vice Chair Klobuchar. And the President is talking about it now and working on it.

Dr. Goolsbee [continuing]. And the President has endorsed that. I championed the—several of the ideas that you mentioned: start-up visas and the green card type policies when I was in the Administration. And I think you do not have to look very far, either in the research literature or just talking to business people, to recognize that immigrants have made not just an important contribution to the legacy of who we are as a Nation, but to the economy.

My friend John Doerr said that 50 percent of the companies that Kleiner-Perkins has funded have at least one founder born outside the United States. And I think on net they are big job creators, and that by doing some of these things that we could have a positive impact.

I think on H1B visas, they do have the complication that you are tied to one employer. So I think there are——

Vice Chair Klobuchar. We actually have made some changes——

Dr. Goolsbee [continuing]. So making changes on that I think is a good idea, as well as expanding the number.

Vice Chair Klobuchar. Okay. Very good.

Well I wanted to thank both of you, first for your knowledge and wisdom and everything you shared with us; but secondly the civility that you set here I think bodes well for the future of this Committee.

I had several Members say this is so unique, how everyone is acting. So I hope that we see more of that going forward. I think we all know we have to come together to solve these challenges. The American People are demanding it, and I thank you for setting a good beginning for this Committee, one that you have testified before it sounds like for 30 years, Dr. Boskin. So you have seen it all in probably many different outfits and hairstyles over the years. But we are very excited.

Chairman Brady and I are going to do a number of hearings obviously on these topics and move forward, but thank you very much for being here. The hearing is adjourned.

[Whereupon, at 11:38 a.m., Thursday, February 28, 2013, the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, JOINT ECONOMIC COMMITTEE

The *Employment Act of 1946* established the Joint Economic Committee to analyze economic issues and make policy recommendations to Congress. As the 37th Chairman of this Committee, I congratulate Senator Amy Klobuchar on becoming Vice Chair and welcome both new and returning Members to the JEC.

While the United States confronts many problems, our most vexing economic challenge is the growth gap—and how we close it? The growth gap between this economic recovery and other recoveries is significant and intensifies our federal spending and debt problems.

The growth gap has two interrelated aspects.

- First, by objective economic measure, the recovery that began in June 2009 remains the weakest among all recoveries after World War II.
- Second, according to many economists, our economy's potential to grow over time has slowed. If true, the average rates of growth and private job creation during this recovery of 2.1 percent and 175,000 per month, respectively, are about as good as our economy will ever perform in the future. And that is unacceptable.

Therefore, it is appropriate that the first hearing of this Committee during the 113th Congress should address this growth gap. Why have economic growth and job creation remained weak? And what should Congress do to boost them?

The anemic nature of the current recovery is indisputable.

- During the current recovery, real GDP increased by 7.5 percent in three and one-half years. In contrast, average real GDP growth during the same period in all post-war recoveries was 17.5 percent. Today's recovery is less than half as strong as the average.
- Real GDP would have to grow at an annual rate of 5.5 percent in each of the next four years merely to catch up with an average recovery by the end of the President's second term. That would be slightly higher than 5.4 percent annual rate that President Reagan achieved during the first four years of his recovery.
- Private payroll employment—that is, jobs along Main Street—has increased by only 5.7 percent since its cycle low. Had this recovery been merely average, private payroll employment would have increased by 9.4 percent. The growth gap means that the United States should have 3.9 million more private jobs today that it does.

Equally troubling is mounting evidence that the annual growth rate for potential real GDP in the future has fallen dramatically. In its most recent Budget and Economic Outlook, the Congressional Budget Office cut its estimate of the potential real GDP growth rate to 2.3 percent, one percentage point below its average since 1950.

One percentage point may not sound like much. However, the real economy doubles in 22 years at a 3.3 percent growth rate. At 2.3 percent, it takes 31.9 years to double, almost a decade longer.

This prospect of a "new normal" for America's economy in which our future economic growth permanently slows by one-third should be a red flag for all Americans.

During this Congress, this Committee will, through hearings and research, investigate the growth gap and how to close it. No doubt some of the growth gap may be due to demographic factors that are not easily amenable to economic policy. However, even a cursory review of recent history strongly suggests that economic and fiscal policies have played the dominant role.

To understand how these policies affect performance, let us compare the generally pro-growth policies and the superior performance of the U.S. economy during the 1980s and 1990s with the generally slow growth policies and the lackluster performance during the last decade.

During the Great Moderation under both Republican and Democratic Presidents and Congresses with Republican, Democratic, and split control, the federal government generally pursued the pro-growth economic policies and achieved outstanding results:

- The size of the federal government, as measured by federal spending, gradually shrank relative to the size of the economy.
- Marginal income tax rates fell. Policymakers focused on reducing the after-tax cost of capital for new business investment, and jobs grew.
- Monetary policy became increasingly rules-based and predictable. Ignoring the employment half of its dual mandate, the Federal Reserve focused on price stability.
- The regulatory burden on businesses and households declined.

- The United States led the world in liberalizing international trade and investment.

Beginning in 2001 under both Republican and Democratic Presidents and Congresses with Republican, Democratic, and split control, the federal government reversed course—in large part due to the terrorist attacks of 9–11—and the results have been disappointing:

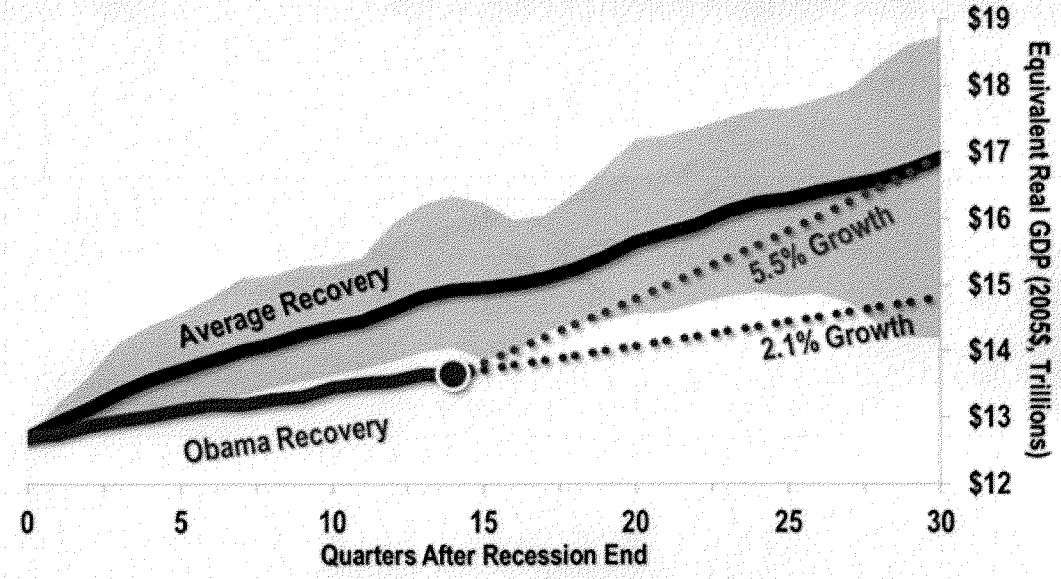
- The size of the federal government, as measured by federal spending, has grown substantially relative to the size of the economy, soaring to 25.2 percent of GDP in fiscal year 2009 and remaining elevated at an estimated 22.2 percent of GDP during the current fiscal year.
- Marginal income tax rates were first decreased then later increased. In recent years, policymakers have primarily focused on the "fairness" of the tax system instead of its effects on growth.
- Monetary policy has become discretionary once again. The Federal Reserve has justified its extraordinary actions based upon the employment half of its dual mandate.
- The regulatory burden on businesses and households has increased, generating uncertainty and inhibiting new business investment.
- The United States has fallen behind its major trading partners in liberalizing international trade and investment.

Today is the perfect time to focus on the growth gap and what we should do to close it. Given the historical and legal relationship between this Committee and the Council of Economic Advisers, it is appropriate that two of its most distinguished former Chairmen, Dr. Michael Boskin and Dr. Austan Goolsbee, are today's witnesses.

With that, I look forward to their testimony.

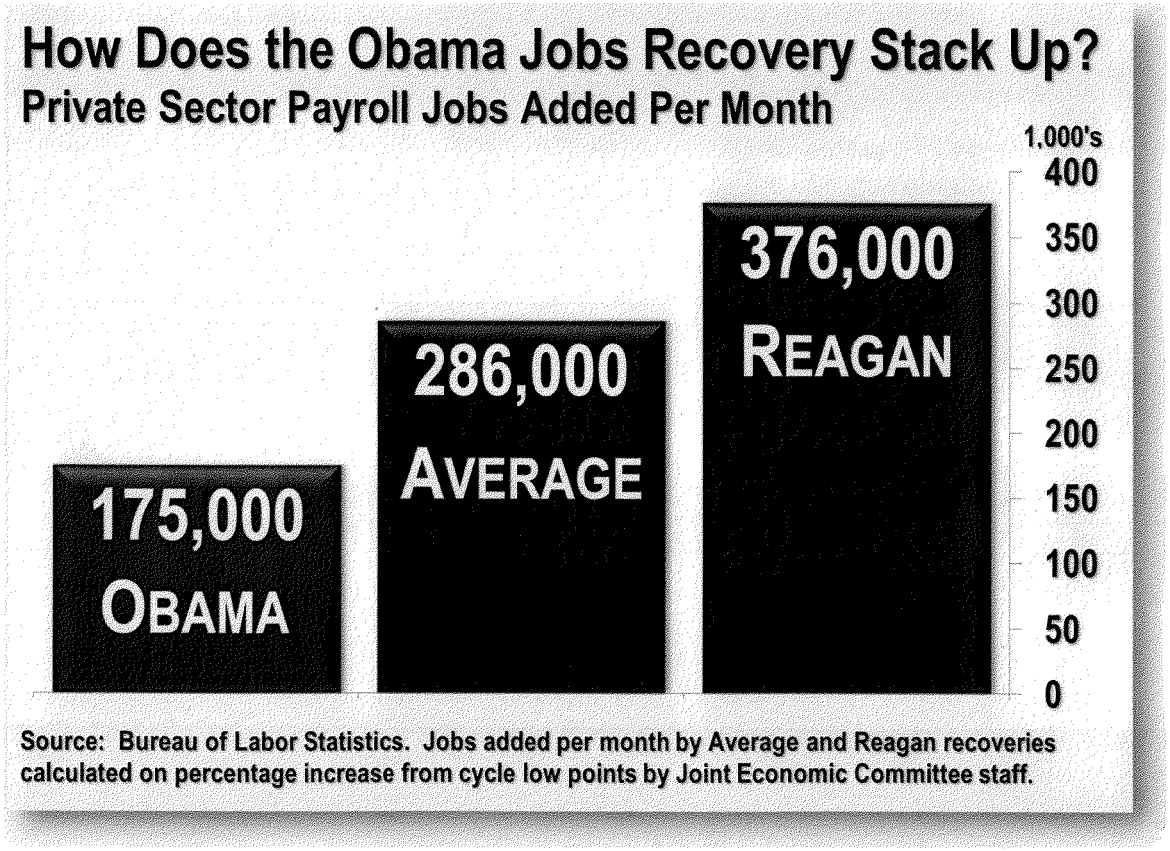
5.5% Growth Rate Needed Over Next 4 Years

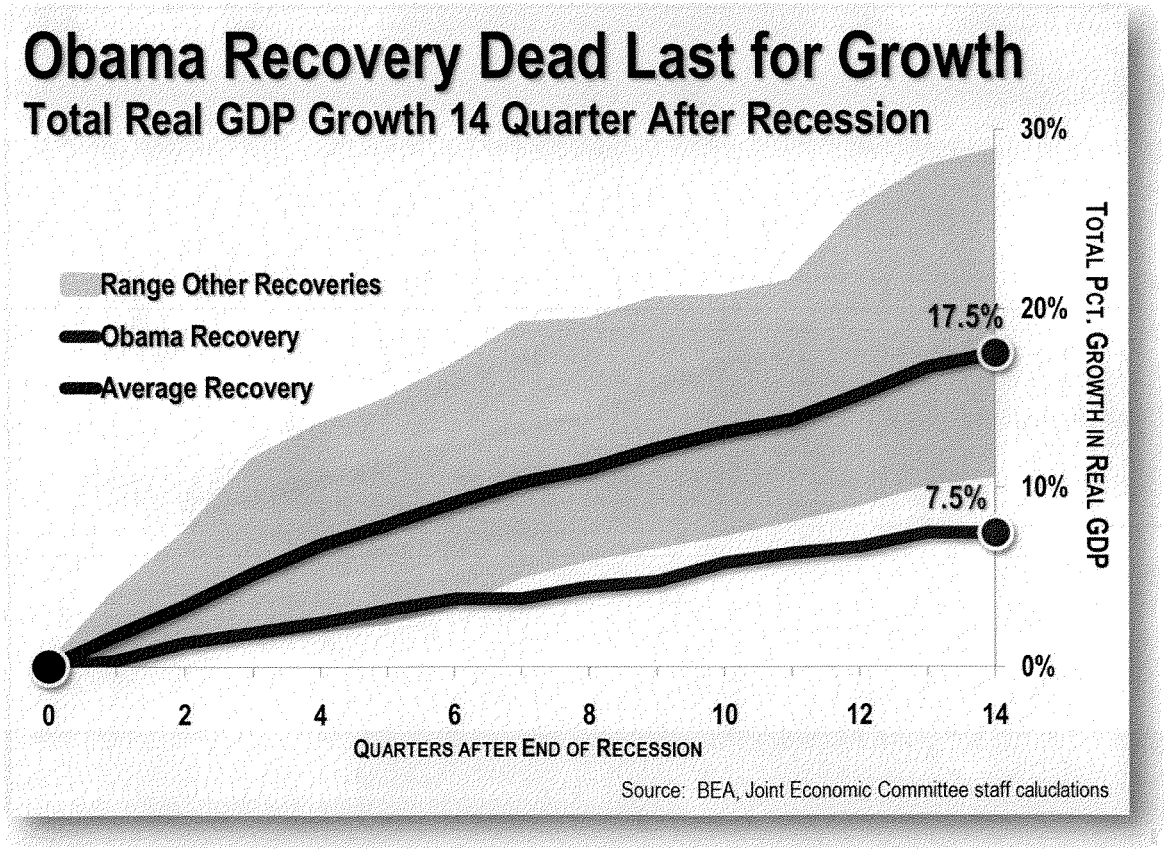
For Obama Recovery to Just Get to Average of Other Post-War Recoveries



Blue Shaded Area represents best and worst of other post-World War II recoveries lasting longer than one year.

Source: BEA, Joint Economic Committee


How Does the Obama Jobs Recovery Stack Up?
Private Sector Payroll Jobs Added Per Month
1,000's
400
350
300
250
200
150
100
50
0
175,000
OBAMA
286,000
AVERAGE
376,000
REAGAN
Source: Bureau of Labor Statistics. Jobs added per month by Average and Reagan recoveries calculated on percentage increase from cycle low points by Joint Economic Committee staff.


Obama Recovery Dead Last for Growth
Total Real GDP Growth 14 Quarter After Recession
Range Other Recoveries
Obama Recovery
Average Recovery
17.5%
7.5%
30%
20%
10%
0%
TOTAL PCT. GROWTH IN REAL GDP
0
2
4
6
8
10
12
14
QUARTERS AFTER END OF RECESSION
Source: BEA, Joint Economic Committee staff caluclations

THE STATE OF THE ECONOMY AND ECONOMIC POLICY

Testimony before the U.S. Congress Joint Economic Committee

Michael J. Boskin

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Hoover Institution Senior Fellow, Stanford University

Washington D.C., February 28, 2013

Chairman Brady, Vice Chair Klobuchar, and members of the Committee, I am pleased to be appearing before you today to discuss the state of the economy, my evaluation of U.S. economic policy, and my suggestions for policies to strengthen economic growth.

The economy remains mired in an anemic recovery from the financial crisis and recession, which was as or more severe than any economic shock since World War II. Unemployment soared, long-term unemployment became entrenched, many more left the labor force, investment plummeted. There were many interrelated causes: the burst housing bubble foremost among them. Two prime causes of the bubble were the serial social engineering of housing and too-loose monetary policy during a boom. Home prices plummeted and housing construction collapsed. The problems spread to other sectors of the economy.

The government undertook unprecedented monetary, fiscal and regulatory responses to the crisis; I believe some were quite helpful, especially early monetary policy, the automatic fiscal stabilizers, and, while done poorly, the capital made

available to the banks. Absent those interventions, I believe the downturn would have been worse.

The unprecedented anemic recovery has been almost as damaging as the recession. Usually recoveries from deep recession are sharp and swift, as in the 1970s and 1980s. Sometimes recoveries from financial crises are slow, though not always. The economy remains well below its potential (Figure 1). Economic growth has averaged roughly 2% per year since the recession ended. Last quarter the economy was essentially flat, and this quarter the Blue Chip forecast again calls for anemic growth (Figure 2).

Figure 1
Blue Chip Consensus U.S. Forecast: Quarterly 2013-14

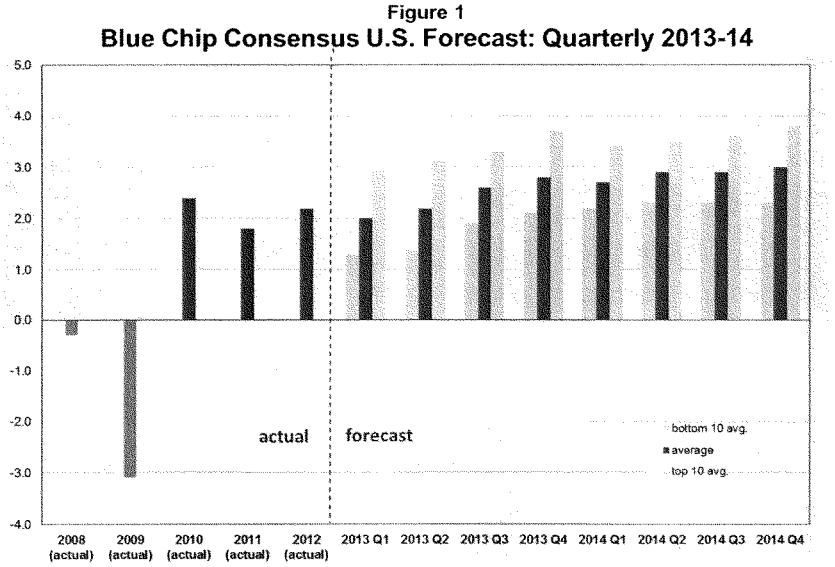
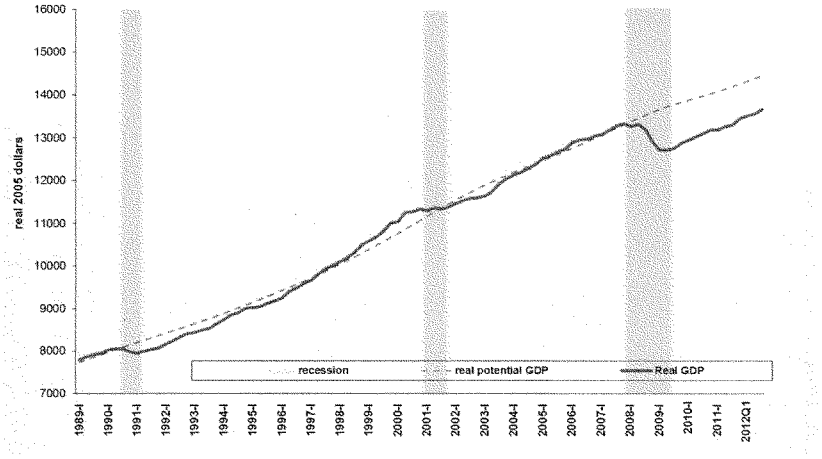


Figure 2
Real GDP



The modestly good news is that these same forecasters project a modest pickup, to a still far-too-low 2.5-3%, this year and next. The CBO has the economy growing at 1.4% this year and 2.5% next; thereafter, 4% for a couple of years. The Administration forecasts a more solid recovery, 2.6% in 2013 and over 4% in 2014.

Every year, the Administration has forecast 4% growth the following two years. Growth has been just half that. So some combination of incorrect interpretation of economic events and unwarranted enthusiasm about the efficacy of its policies led the Administration awry.

I am generally in agreement with the Blue Chip Consensus Forecast as a base case. However, I see considerable risk of doing worse over the next couple of years and some opportunities to do better.

The main risks in the short run stem from 1) fiscal policy, especially any additional tax hikes, and the inability to agree on medium and long-run fiscal consolidation based primarily on slowing the growth of spending; 2) Europe's deepening recession, which affects roughly 20% of our exports. Its debt and banking crises remain a major problem, not just for Europe but for America and the global economy. Europe's banks are more thinly capitalized than American banks, but extend a larger share of credit in the economy as compared to credit markets. 3) China, now the world's second largest economy, is early in a political transition and must deal with a complex array of its own problems; 4) geopolitical issues, e.g. Iranian oil; a worst- case scenario could be severe enough to cause a recession. 5) Continued deleveraging of the private sector, still in middle innings; 6) Still tight credit for small business; 7) additional regulation raising still higher the cost and uncertainty caused by the explosion of regulation in recent years; wide swaths of the economy are being forced into non-commercial decisions by health care reform, Dodd-Frank, and EPA regulation, whatever their noneconomic benefits may be; 8) monetary policy exit risk. The Fed is projected to have a balance sheet of $4T by 2014. QE has hit diminishing returns; still more excess reserves won't ease bank lending. Boosting asset prices risks bubbles that can burst to serious disruption. The Fed says it will raise interest on reserves to keep the banks from lending too rapidly, which risks inflation. But especially given recent history, it is hard to imagine the public and the Congress sitting by while the Federal Reserve gives, not lends, tens of billions of dollars to banks.

If we are fortunate enough that these risks do not materialize or are ameliorated quickly, there is certainly lots of opportunity for the economy to do better than projected. 1) Housing has finally begun to rebound. Although from a smaller base, it is now adding to, rather than subtracting from, growth; 2) fiscal drag from state and local tax hikes and spending cuts has likely peaked; 3) technology revolution – "fracking" – has created a boom in domestic oil and gas, which is generating jobs, incomes, and government revenues. Combined with greater offshore drilling permits, Canadian oil, and the once-unimaginable possible opening up of Mexico's oil industry to foreign investment, we have the opportunity to dramatically reduce OPEC's strategic power. This is not just a potential economic revolution, at least, if policy or unsafe development doesn't kill it, but one of the most important geopolitical shifts in America's favor in decades. Lots of cash is available on the sidelines, earning virtually nothing in relatively safe assets, on household and corporate balance sheets. Businesses are waiting for more favorable investment and hiring opportunities in a stronger economy and a more favorable expectation of the future tax and regulatory environment.

To see just how weak the recovery has been so far, see Figures 2, 3 and 4. Figure 2 demonstrates the economy has made up very little ground on its potential. The output gap is still large. This is because the recovery has been so anemic compared to recoveries from the other two deep post-World War II recessions. Those recoveries – in the mid-1970s and mid-1980s – were sharp and strong. As Figure 3 shows, GDP growth in the current recovery has been only 40% as strong.

Even worse, the jobs recovery has been running at only a 20% pace. In their first three and one-half years, the earlier recoveries generated, adjusted for the growth in working age population, an average of 14.3 million jobs. The current recovery is 10 million jobs short.

Figure 3
Average U.S. Real GDP Growth First 14 Full Quarters After Severe Recession Trough

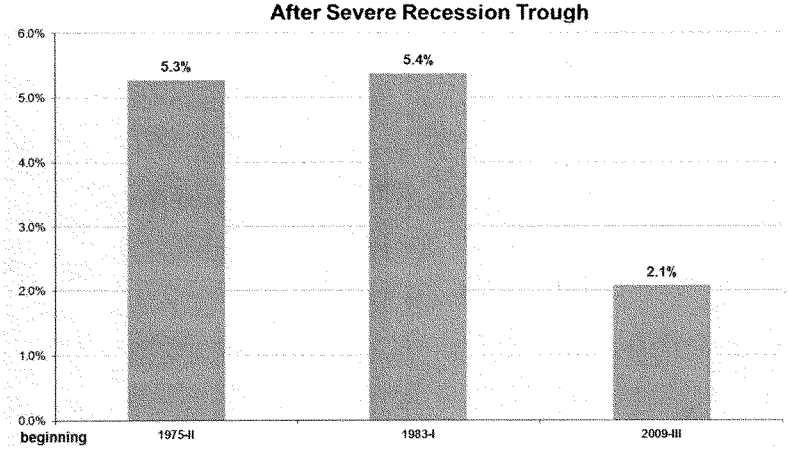
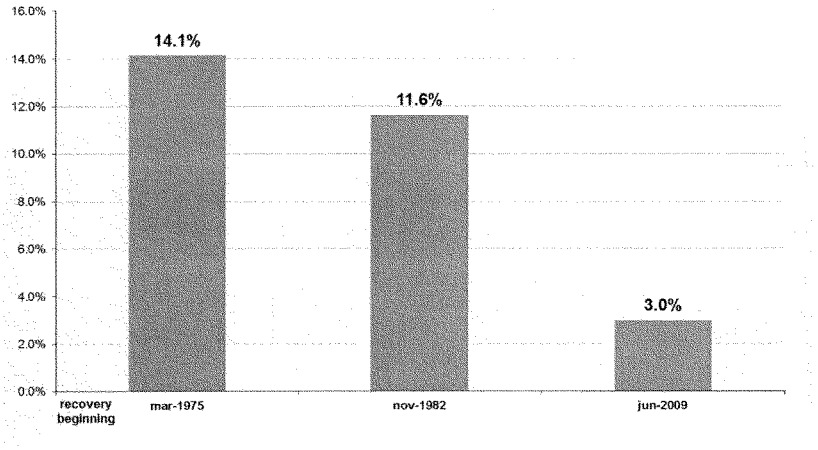


Figure 4
U.S. Job Growth First 43 Months After Severe Recession Trough



There are undoubtedly many reasons for this poor performance, including continued deleveraging, global economic problems, and others, but some unfortunate policy choices have contributed significantly by raising costs and adding uncertainty to an already uncertain economic environment.

The discretionary fiscal policy response to the recession, while timely, was poorly designed and implemented. There are many studies of its efficacy or lack thereof. Opinions of the net effects of the stimulus bill range from negative to adding 3+ million temporary jobs.

The $825 billion stimulus bill thus cost hundreds of thousands of dollars per job, many times median pay, even on the Administration's jobs estimate, far more on

others. Cash for Clunkers cost $3 billion merely to shift car sales forward a few months; its CO_2 emissions savings cost twenty times the EU carbon trading price. The PPIP program to buy toxic assets from the banks to speed lending generated just 3% of the $1 trillion planned. The temporary, inframarginal tax cuts hardly budged private spending; the analogous, smaller, Bush '43 2008 tax cuts had virtually no effect on private spending.

And, as the President stated, "the 'shovel-ready" stimulus projects weren't ready'"; (actually, modern public infrastructure projects they use large equipment, not many shovels). And Harvard's Ed Glaser concludes that infrastructure is poor stimulus because "good infrastructure planning takes years". The nation certainly has infrastructure needs, some appropriately federally financed, but those should be dealt with in the normal authorization and appropriations process.

A recession is the worst possible time to try to reengineer large sectors of the economy, from health care to energy to financial services, as the greatly increased uncertainty and prospective higher costs froze investment and hiring.

If these policies had been likely to strengthen short-run growth at reasonable long-run cost, I would have supported them. Unfortunately, the emphasis on short-run, temporary spending increases and inframarginal tax cuts, in combination with the attempted re-engineering, did little, if any, good for the large cost.

Economists long ago concluded that most consumption is driven by expectations of future after-tax income, not current short-run disposable income. And businesses invest for future profits and, hence, are sensitive to expectations of

future tax rates. Both the prospects of higher taxes from both legislation and the explosion of debt, plus the added uncertainty were a serious hindrance to short-run, not just future, economic growth.

The action I believe would help the economy most in both the short and long run would be a strong, credible commitment to serious fiscal consolidation, phased in gradually as the economy recovers. It should be difficult to reverse, absent a major emergency such as war or recession. That means permanent, structural changes, not just a specific dollar cut, easily reversible in the next round of appropriations. It likely also requires toughened budget process rules on spending and debt.

Pro-growth tax reform -- "lower rates on a broader base " – can be an extremely valuable complement to spending control. The present discounted value of future taxes must cover the present value of future spending, plus the national debt (net of assets). In short, the government must pay for spending with taxes, now or in the future. So the *only* way to prevent large tax increases is to control spending growth. Put another way, spending control is also tax reform.

The harm from higher tax rates distorting decisions to work, save and invest rises with the square of the rates. Doubling the rate quadruples its harm. This is not doctrinal; it has to do with the area under supply and demand curves taught in every Introductory Economics course. This is why economists favor broad-bases and low

rates. Worse yet, the same economic activity is often taxed multiple times: e.g. wages by federal, state, and local income taxes and payroll taxes.

Especially worrisome is America's high corporate tax rate (the statutory rate is the highest in the OECD; the effective rate also out of line, but not as far). We should transition to broad-based income taxes with the lowest rates possible to raise necessary revenue, ideally integrating the corporate taxes and the personal tax.

The potential benefits from stylized tax reform are large. Several studies show income gains of 6+% from comprehensive broad-based low rate(s) consumption tax reform. That is about one-fifth of the difference in per capita income between U.S. and Western Europe. Economists debate what fraction of that difference is due to higher European tax rates and bloated welfare state, from under half to 100%. But clearly, tax reform can be an important effective complement to spending control.

The Long Run

Turning attention to the long run, Americans are more pessimistic than at any time in many decades. Record numbers are doubting that their children's and grandchildren's standard of living will be higher than ours. They wonder whether we will ever get back to normal, or are in a new normal of much slower growth or even Japanese-style long-run stagnation. They wonder whether the expansion of temporary programs will become permanent; whether the lurch toward a European-style social welfare state will stop; and if some combination of monetary policy and exploding government debt will lead eventually to high inflation. And the anemic

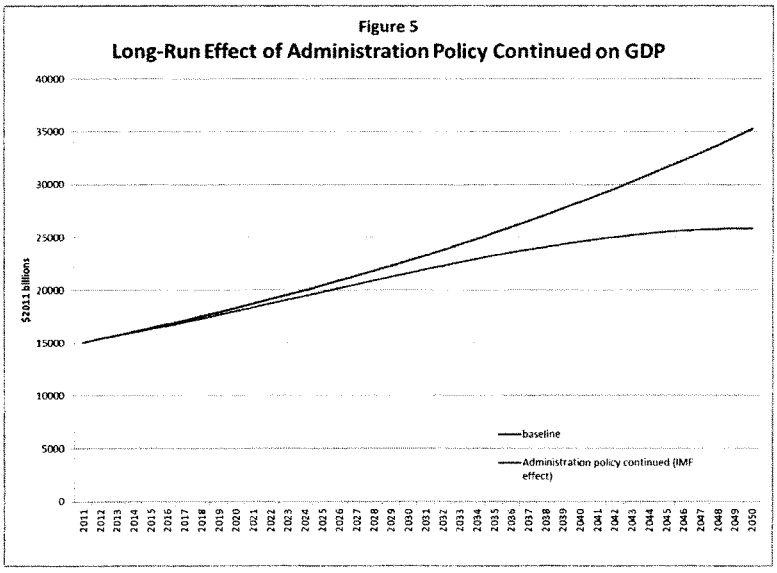
jobs recovery has many wondering if we will ever get back to full employment, or whether it is primarily a cyclical problem or a permanent change in labor markets

Worse yet, the almost-doubling of the debt-GDP ratio since before the crisis, and the prospect of much larger debt and deficits from the explosion of entitlement costs, (perhaps following a few years of lower deficits and relatively stable debt-GDP ratios), have Americans worried for their and their children's future. We hear that the debt is unsustainable. That is far too antiseptic a term. It is dangerous.

How does a high debt-GDP ratio slow growth? Higher debt ratios eventually crowd out investment, as holdings of government debt replace capital in private portfolios. The lower tangible capital formation reduces future income, especially future wages. To the extent the reduced capital formation slows the development and dissemination of new technology, this effect will be amplified. Every dollar borrowed requires future interest be paid, whose present discounted value equals the debt. So future taxes must go up to cover the interest unless future spending is cut. The prospect and then reality of higher tax rates, plus increased uncertainty about future fiscal policy, slows growth and also raises the specter of higher inflation eroding the value of the government debt and/or a financial crisis, which might sharply raise interest rates.

How high would tax rates go? To finance projected entitlement cost growth, marginal tax rates would exceed 70% for many middle-income families, higher still at the top.

I recently described four different ways to calculate the effect of the projected U.S. debt ratio soaring to over 100% next decade, rising exponentially thereafter. They are based on alternative methodologies and highly regarded studies.[1] The results, using the effect from an International Monetary Fund study, are presented in Figure 5.



The IMF study by Kumar and Woo analyzes the effects of higher debt-GDP ratios in a panel of advanced and developing countries over the past four decades.

[1] It presents an intermediate case, between the CBO's more optimistic baseline and alternative fiscal scenario. I took the Administration's *own projection* of deficits and debt, based on the President's policies continuing, with two modest adjustments: 1) I lowered the growth rate, which was well above the CBO growth rate, to closer to the CBO rate; and 2) I split the difference in the debt effect from the OMB baseline, which is optimistic about the beneficial effects of the Administration's health care reform on health costs, and OMB's alternative scenario, with health care costs growing at close to the long-run average excess over GDP. In any event, this is just to get a baseline. The effects of the debt on growth and future incomes would be quite similar with these other baselines.

They estimate that each 10 percent increase in the debt-GDP ratio reduces the growth rate by 0.17 percent.[2]

The negative effect on GDP grows and, by 2050, the higher debt ratio brings growth to a halt. The level of GDP is 30 percent lower than if the debt had not soared and the policies had not continued. That's most of a generation of per capita income gains wiped out or, put another way, it is as large as the gap between American and lower Western European per capita incomes. Even at half this size, the damaging effect of debt accumulation on growth is enormous.[3]

If the Administration policies, which, in part, reflect inherited spending commitments and tax rules, and notably do not reform Social Security and Medicare, were altered and the debt-GDP ratio permanently stabilized or, better yet, gradually decreased, the harmful effects would be correspondingly attenuated.

Failing to rapidly begin bending the long-run debt-GDP curve down risks a growth disaster, whose severity could be much worse than the recent deep recession and tragically anemic recovery. Left unchecked, it eventually risks a lost

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[2] Just as higher debt ratios can affect the rate of economic growth, the growth rate certainly affects debt ratios. Other factors can affect both debt and growth. So it is no simple matter to clearly identify the causal relationships statistically. While the IMF study deals extensively with reverse causality and endogeneity issues, they are a reason to use alternate studies with somewhat different data and methodologies.

[3] The analogous calculation based on the effect estimated by Carmen Reinhart and Ken Rogoff is over 20% lower GDP. For comparison, the Congressional Budget Office uses its macroeconometric model fit to U.S. data to estimate the effect of debt accumulation consistent with its Alternative Fiscal Scenario. CBO concludes it would cause GNP to decline 13.3 percent by 2037 and then is so large and out of the range of experience, it cannot be calculated thereafter, but presumably is vastly higher. Finally, a simple, textbook constant-returns Cobb-Douglas production function, with a one-third capital, two-thirds labor share of income, when combined with the projected debt accumulation and full crowding out, implies a reduction in output of about 17 percent by 2050, more if the reduced investment slows technology dissemination.

generation of growth, a long-run growth depression. The economic "gain" from the political "pain" of seriously reforming entitlement cost growth is therefore enormous.

Recent research suggests the short-run impact of more government spending is likely to be small or even negative, conversely for cuts, if the debt-GDP ratio is high, it occurs during expansions not recessions, is on non-military purchases, the economy has flexible exchange rates, and/or people expect higher taxes once the Fed exits the zero lower bound on interest rates. *All* apply to the current United States. So the spending reduction this year from the sequester, only about one quarter of one percent of GDP in outlays anyway is unlikely to be a major macroeconomic event. Specific dislocations can be minimized by giving agencies more flexibility in making cuts.

Recent research also reveals fiscal consolidations in OECD countries since WWII that stabilize the budget without recession averaged $5-6 of *actual* spending cuts per dollar of tax hikes. Spending cuts, especially in entitlements and transfers, were far less likely to cause recessions than tax increases and in some cases increased growth. A dozen recent studies in peer-reviewed journals, including one by president Obama's first CEA Chair, unanimously document the negative effects on the economy of higher taxes. Since the American economy differs in some ways from these other cases – it comprises over one-fifth of the world economy, interest rates are already low, the dollar is the global reserve currency, and many countries are consolidating simultaneously -- we should be cautious about claiming too much for the short-run benefits of fiscal consolidation.

An economically balanced deficit-reduction program is $5 actual, not hypothetical, spending cuts per dollar of tax hikes. In summary, gradually consolidating the budget by slowing spending growth, minimizing both tax hikes and the impacts on military spending, is the economically soundest course of action.

CBO projects annual federal spending will increase by $2.4 trillion to $5.9 trillion in a decade, or by two-thirds, even if the $110 billion annual sequester or its equivalent stands. Continued delay in spending control to avoid even minor potential economic impact leaves a long boom as the only time to control spending. But a long boom is far less likely if we don't control our debt. Indeed, the latest research suggests our debt-GDP ratio may be on the verge of a tipping point. Beyond that point, interest rates could unexpectedly rise quite rapidly, which would require a shift to a large, lengthy, politically untenable, primary budget surplus, or risk a sovereign debt crisis.

One successful example of spending control occurred in the mid-1990s under President Clinton and a Republican Congress, but more commonly, as in Washington and many states in the 2000s, the opposite occurs: a boom brings a surge in revenues and politicians are anxious to spread the spending far and wide. Ideally, spending reductions would be phased in as the economy recovers, but it is difficult to make a convincing case that they will indeed occur, given the political economy of the budget, the history of most previous budget agreements and the inability of one Congress to bind the next.

I thus conclude that the policy priorities should be:

1) Medium-run fiscal consolidation and tax reform, as described above, enacted as soon as possible, and difficult to reverse, but phasing in gradually as the economy recovers.

2) Long-run entitlement reforms that minimize work and saving disincentives while reducing subsidies to the well-off. For Social Security, the best avenues are altering its indexing and possibly higher retirement age, while maintaining the early retirement option, again phased in gradually. For Medicare, greater competition and more means-testing, e.g. graduated, subsidies to purchase coverage.

3) Budget reform: making programs more effective by eliminating, consolidating and modernizing, e.g. for job training; replacing some of the 40% of the federal civilian work force retiring in the next 10 years with technology, one-stop-shopping; IT spending reform; better balancing the need for temporary economic and humanitarian support with incentives to return to work in transfer programs.

4) Far more predictable and permanent fiscal and monetary policies which are rules-based, i.e., follow clear, predictable guidelines with prescribed limits, except in extreme emergencies such as war and recession. Start by eliminating endless use of temporary tax rules and new spending programs.

5) The policy steps outlined in 1-4 above would be strongly reinforced with international trade liberalization, sensible regulatory reform and human capital policy reform.

Chairman Brady, Vice Chair Klobuchar, and other members of the Committee, I strongly believe that if policy moved in the direction I have suggested, both short and long-run economic growth and concomitant growth in incomes and employment, would increase significantly.

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PREPARED STATEMENT OF HON. AUSTAN GOOLSBEE

Thank you, Chairman Brady and Vice-Chair Klobuchar for inviting me today to discuss the nature of the recovery in the United States.

The central question we have confronted in the economy in recent years is this: why has the economy not grown faster after such a deep recession?

I believe there are three basic reasons for that but before laying those out, I would like to first fix the facts on the nature of our current economic recovery. I have heard the statement that this is the weakest recovery ever. That is factually incorrect. This recovery is not the weakest recovery in recent memory. It is not even the weakest recovery of the last two recoveries. Measured from the trough, the 2001 recovery was substantially weaker. On the employment side, the jobs picture continued deteriorating for, literally, two and a half years after the 2001 recession's declared end date. This time it was 8 months.

Measured by the speed of decline in the unemployment rate, the rise of GDP or the percentage increase in the number of jobs, this recovery has been below average compared to past recoveries but substantially better than in 2001. It has not been fast enough, certainly. But there is not any question at all that conditions have improved.

The important question, though, is: why there was not a "V-shaped" recovery following such a deep recession? Certainly compared to 1982–1984 and older episodes of big recessions when deep recessions led to rapid rebounds, this time, the recovery has looked more like the last two recoveries which followed much shallower recessions than it has looked like 1984.

In my opinion there are three basic reasons the recovery is not faster right now:

1) Recessions from Popping Bubbles Are Much Harder To Recover From

When my dear friend and mentor, former Fed chair Paul Volcker, raised interest rates above 20% in the early 1980s, economic activity slowed dramatically. When rates came down, people went right back to doing what they were doing before the recession began. The key component to a V-shaped recovery is not requiring a lot of structural transformation.

This recession resulted from the popping of a bubble so we were not able to return to business as it was before the recession. As we documented in the Economic Report of the President in 2011 when I was serving on the Council of Economic Advisers, the expansion of the 2000s in the United States was heavily driven by residential investment and consumer spending—much more so than past expansions in the U.S. and much more so than other advanced economies during the 2000s.

There was a joke headline in The Onion you may have seen: "Furious Nation Demands New Bubble to Invest in to Restore Prosperity." Shifting the main drivers of growth away from housing construction and spending growing faster than income and toward exports, business investment and more sustainable forms of expansion entails retraining, labor mobility and time. There really isn't a get-rich-quick-scheme to do it, and that's a big reason the recovery hasn't been faster.

Add to the problem that the necessary shift to exports has been complicated by the stagnation and shrinkage in some of our traditionally largest export markets and you can understand why recovery hasn't been faster. Our modest growth of 2–2.5% per year has been among the best in the advanced world. It's been a very rough patch for the world economy.

With regard to jobs and unemployment, I don't think there is any secret to how things go. Over time, productivity grows about 2% per year. If output grows faster than that, then companies must hire or get more hours from their existing workers. The periods of relatively rapid decline in the unemployment rate in the last two and a half years have corresponded to periods when the growth rate got up above 2%. When output grows less than 2%, companies really don't need to hire additional workers to grow that fast and the unemployment rate stagnates or gets worse.

The good news is that exports and investment have rebounded, firm profitability has, literally, never been higher as a share of GDP and interest rates and the cost of capital are epically low. Once companies feel that the overcapacity problem has ended and they can expect a sustainable increase in demand, the stage is definitely set for an investment increase. You have seen this already in some sectors. Congress should be doing everything it can to encourage export growth and investment at home. I can go into more detail on these steps if you like but suffice to say that there are many policies that have garnered bipartisan support in past years which could help.

2) Overcoming the Worst Housing Market in History Has Undermined Growth

There has never been a housing collapse like the one we just experienced. Housing is normally the most important cyclical sector in the economy, accounting for about one-third of the growth in the typical expansion. Economist Ed Leamer has documented quite clearly the outsized importance of housing and construction for the short-run business cycle.

So I think it's pretty understandable why the V-shaped recovery model doesn't work when your recession comes from a popping bubble in real estate. Prices grew so far above construction costs in this country that new housing construction exploded to absolutely record levels. Since prices fell, we have had to work through an astonishingly large inventory of vacant homes. At one point there were more than 6 million vacant properties in the country. Normally construction and housing might account for as much as a third of an expansion, but in this kind of environment, they contribute nothing. Who needs to build new houses when there are millions of vacant ones? That major hit on the growth rate also helps explain why there has been no V-shaped recovery.

In the immediate term, the positive side is that in many if not most housing markets around the country, prices seem to have begun rising and we have seen the first vestiges of a return to a normal contribution of the housing sector to growth. This alone would go a fair way to returning growth to a more normal level. Congress could help this process, in my opinion, by facilitating refinancings for people unable to take advantage of low rates because they are underwater and by facilitating the conversion of vacant homes into rental properties. Longer term, most economists would like to see a rational resolution of the country's housing finance system to get the government out of the business of backing 95+% of the mortgage activity in the nation. But it doesn't seem to be on Congress' primary agenda at the moment.

3) Financial Crises and Deleveraging Take a Big Toll on Growth

As our financial system continues its attempts to recover from the crisis, it has complicated the recovery, as it always does whenever there are major financial crises and forced deleveraging. The Economic Report of the President in 2012 documented that the U.S.'s labor market experience has actually been a fair bit better than the average for countries that have lived through financial crises like the one we just endured.

The good news is that consumer deleveraging may have almost run its course now. Several important measures of consumer and small business credit have begun to expand again, albeit modestly. But the international experience with events like the one we just lived through suggest that years of slower than normal growth result from financial crises. Congress could address this issue by trying to get more principal reduction in underwater mortgages, which is the primary form of consumer debt overhang, but that subject has been a vexing one for some time so I think policy may not make much of a dent in the near term.

Let me take a brief moment to mention two things that I believe the data do NOT suggest are primary shackles on our current recovery.

1) Regulation/Policy Changes Are Not the Main Source of Modest Recovery

Some commentators have argued that the policy decisions and regulatory changes of the past three years have been the primary cause of slow investment and modest growth. Anyone that argues this must explain why the patterns of behavior we see in the U.S., like the accumulation of money on corporate balance sheets without a big increase in investment, are prevalent in virtually every advanced country of the world. Places that did not enact any of the policies of the last four years still had the same experience.

I have noted in the Wall Street Journal and in other venues that economists' normal methods of detecting the negative economic impact of a policy or a regulation such as comparing places or industries affected and not affected by a particular policy do not, in this case, seem to indicate that policies have been especially important as a primary influence on the recovery. This is true for industries most and least affected by the health plan, energy policy, and so on.

2) The Short-Run Deficit Is Not the Main Source of Modest Recovery

It should be clear to anyone who looks at the CBO projections of the last two decades that the business cycle is an overwhelmingly important driver of the short-run deficit and that the large majority of the increase in the deficit in 2009 to today came directly from the slowdown, not from any explicit change in policy. That is the same reason (in reverse) that government spending and the deficit are now shrinking at the fastest rate in decades. The notion that short-run austerity would increase the U.S. growth rate has not been borne out in the data at all. European

countries engaging in austerity have seen their growth rates plunge and their economies shrink.

The idea that fiscal contractions could be expansionary normally relies on austerity improving investor confidence and, in turn, generating lower interest rates which expands output. Interest rates on U.S. debt remain at epically low levels. Central bankers are debating what to do when facing the zero lower bound. Arguing that major immediate cuts to government spending would increase growth requires at least giving a mechanism of how it would work in this kind of environment.

I am a long time advocate of the nation confronting the long-run fiscal imbalance it faces from the aging of our population and the rise of health care costs. I hope Congress will work with the President to sign a so-called grand bargain that will address those issues and think about the level of tax revenue needed to pay for it. But in my opinion, major immediate-term cuts in government spending beyond the unprecedented drops in spending as a share of the economy that are already underway will have the same kind of heavily negative impact on the growth rate that we have seen in other countries of the world and that we saw in the fourth quarter GDP number in the United States.

CONCLUSION

I think that the difficult experience for the U.S. and for the world over these past several years will soon be coming to an end. It has been a brutal episode in our history and one that we should come together to rise above. The key is promoting growth. I believe Congress and the Administration could have a positive impact on the long-run growth rate of the economy and job market by putting a focus on expanding exports, encouraging private-sector investment at home, upgrading the skills of the workforce and ensuring that the economic infrastructure and intellectual property of the country are secure. Innovation has driven our growth for at least 200 plus years and we should invest in keeping it that way.

Thank you for your time.

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COMMITTEES:
ENERGY AND NATURAL RESOURCES
INTELLIGENCE
JOINT ECONOMIC

U.S. Senator Martin Heinrich

Questions for the Record

Joint Economic Committee hearing held on February 28, 2013, titled "State of the U.S. Economy: Why have Economic Growth and Job Creation Remained Weak? And What Should Congress Do to Boost Them?

For Professor Austan Goolsbee

Question 1:

One complaint heard from some members of Congress is that the size of the federal government has exploded under President Obama and that much of that is due to federal stimulus spending. They also claim we have to shrink the government to spur economic and job growth.

I do not believe this an accurate complaint or one based on present facts. The truth is that government at all levels is now smaller than it was before the start of the recession in 2007. In fact, the *New York Times* reported in a February 26 story titled "Austerity Kills Government Jobs as Cuts to Budgets Loom" that "[f]ederal, state and local governments now employ 500,000 fewer workers than they did on the eve of the recession in 2007, the longest and deepest decline in total government employment since the aftermath of World War II." A graphic associated with that article points out that over the last two years all government consumption and investment experienced its largest drop in more than 50 years. In addition, Congress working with President Obama has taken steps to reduce the deficit by about $2.5 trillion in the next decade.

a. Would you agree that those calling for spending cuts and smaller government have already gotten a lot of what they want?

b. What has been the impact to the economy from public sector job loses?

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Question 2:

An area I have followed closely since coming to Congress is export controls. One thing about the current export control regime that has concerned me is the licensing process for items on the State Department's munitions list. Every single item – every nut, every bolt, or whatever – has to be individually licensed for export if an end-item, like an aircraft, containing that component is on the list.

In 2010, the federal government required a specific license for 10 percent of all exports from New Mexico due to something being on that list. In addition, every business that manufactures a product or component on the list, regardless of size, must pay a $2,250 minimum registration fee every year, even if the companies are NOT exporting the item. In fact, 68 percent of registered companies do not even export. These fees can harm American small businesses as international markets become increasingly competitive.

I agree that sensitive technologies must remain under control, but there must be something that can be done to prioritize our controls so that a minor component of an aircraft or vehicle is not controlled in the same manner as the aircraft or vehicle itself. I worked with my colleagues in Congress to help pass satellite export control reform in last year's National Defense Authorization Act. This will help make our nation's satellite and aerospace industries more competitive, but there is much more work to do.

a. What are your thoughts on export controls and their impact on economic and job growth?

Question 3:

A key factor for growth is applying U.S. scientific and technological research to manufacturing and other commercial applications. However a number of studies, including by the National Research Council in 2010, identifies U.S. export controls as an obstacle to translating scientific research into U.S. commercial leadership.

a. Do you have any thoughts on this view?

RESPONSES FROM HON. AUSTAN GOOLSBEE TO QUESTIONS POSED BY SENATOR MARTIN HEINRICH

1. I think it is important for us to avoid confusing the effects of recession from underlying trends. When the administration's critics say government has grown under President Obama and cite government spending as a share of GDP, they are confusing the business cycle with policy change. The overwhelming reason government spending grew in the initial years of the Administration is that we had a terrible recession. Every recession leads to an increase in that ratio, and this one was worse than any other. Employing their own logic, those same critics should be praising the Administration for lowering taxes more than any president before for taxes as a share of GDP plunged unprecedentdly in the recession.

As you observe, both the deficit and government spending are now dropping at the fastest rates in a half century, and most private sector analysts believe that additional austerity in the short run will undermine growth in the U.S. just as it has done in Europe. I believe that the Nation still faces the same long-run fiscal problem it has known about for 50 years and that we will need to address it. But that problem has virtually nothing to do with the reason deficits rose in the recession.

To the second part of your question, as a factual matter, the decline of public sector employment and especially state level teachers and other workers have been one of the primary reasons the job market has not recovered to pre-recession health.

2. I agree with both parts of your statement: we should be sensitive to national security technology getting into the wrong hands AND we should constantly be evaluating whether our export controls are doing that in the least intrusive way possible with as little disruption of private sector growth as we can. I am not familiar with the specifics on satellite technology or other engineering technologies, but I do think that being too restrictive or even merely being too slow to update what is cutting-edge technology can have a negative impact on the economy, and we should fix it.

3. This relates closely to your previous question. Without getting into specific industries, I generally concur with the NRC report that if export controls are not applied judiciously, it can harm competitive leadership of U.S. companies. We should be especially mindful of applying excessive controls when there is international competition in the industry. It does little for our national security if we forbid a U.S. company from selling some satellite part, say, but the technology is already available on the open market from competing firms not in the United States.

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