Strengthening America's Economy

The President's Jobs and Growth Proposals

Council of Economic Advisers

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The Economic Situation

The economy continues to recover from the effects of the slowdown that began in the middle of 2000 and led to the subsequent recession. The past three years have presented a number of challenges to the American economy, including the terrorist attacks of September 2001, the long decline in the stock market, and the effects of corporate governance scandals. The long-run economic outlook remains solid—with low inflation, low interest rates, and strong productivity gains that suggest that the post-1995 acceleration in productivity will continue to raise real incomes and living standards.

Yet the pace of the expansion has not been satisfactory, with business investment and job creation remaining key weak spots in the economy. A plunge in investment that began in the third quarter of 2000, along with the declines in equity markets that began in the first quarter of that year, were important forces in the recession. Purchases of equipment and software picked up modestly in the latter three quarters of 2002, but new orders for non-defense capital goods—a forward-looking indicator of investment—stagnated in the middle of the year and then declined in the last quarter. Moreover, high office and industrial vacancy rates continue to depress investment in commercial structures.

Household spending, notably on autos and housing, has played a key role in the recovery thus far. Spending has been supported by the continued growth of real personal income, which has been more resilient than in previous business cycles, as a result of both the 2001 tax cut and supportive monetary policy. Low interest rates have contributed to special financing incentives for automobile purchases and low mortgage interest rates. New home sales were at record levels in November and December. These developments in part reflect the fact that household income growth has been more stable than in the typical postwar recession, in which incomes and net worth have moved together. In contrast, net worth has fallen dramatically relative to income over the past three years. While stock price declines have eroded household wealth, the appreciation of equity prices before 2000 would have been expected to increase consumption over the subsequent period. Some of the drop in consumption expected to result from the post-2000 declines may thus simply represent a "cancellation" of an implied consumption increase that had not yet taken place. The positive influences on consumption from current income and the continuing appreciation in housing wealth might thus have offset the stock market's negative effects on personal spending, leading to the continuing buoyancy of household spending. Even so, the possibility that consumers might pull back represents a risk to the recovery in the near term.

Declining equity prices also have important effects on businesses by raising the cost of financing new investment. Lower share prices mean that firms must sell a larger share of the company to raise a given amount of new equity to finance new investment. In addition, lower stock prices mean higher leverage—the ratio of the market value of outstanding debt to equity—possibly increasing firms' cost of raising debt-financed capital. Higher costs of raising new capital inhibit reduce investment spending.

A stronger recovery depends on a robust rebound in business investment. This is the key factor to creating more jobs—when companies build new factories, they hire workers and boost employment in capital-goods industries. Thus far in the recovery, the labor market remains a weak spot, with the unemployment rate reaching 6.0 percent in November and December.

In this setting, the goal of the President's proposals is to provide near-term support for the economy while enhancing long-term efficiency and growth. The proposals can further be seen as providing insurance against potential risks to the recovery, including an investment recovery that is delayed or more anemic than currently anticipated by professional forecasters. Threats to the investment recovery include weaker-than-expected profit growth, high required rates of return arising from geopolitical and other risks, and a prolonged period of balance-sheet repair.

More general risks to the recovery include an increased sense of caution that leads families to pull back on their spending plans, and the potential for further terrorist attacks. Indeed, some of these risks could become linked; for example, if firms become uncertain about the strength of consumer demand, they may put investment plans on hold.

The President's Proposals

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

1. Accelerate to January 1, 2003 features of the 2001 tax cut currently scheduled to be phased-in: the reductions in marginal income tax rates, additional marriage penalty relief, a larger child credit, and a wider 10 percent income tax bracket.

2. Eliminate the double taxation of corporate income, whether paid to individuals as dividends or retained by firms. Dividend income will no longer be taxable on the individual level, while a step-up in cost basis will reflect the effect of retained earnings on share prices.

3. Increase to $75,000 from $25,000 the amount that small businesses may deduct from taxable income in the year that investment takes place.

4. Provide $3.6 billion to fund Personal Reemployment Accounts. These accounts provide up to $3,000 to assist unemployed workers who are likely to need help in finding or training for a new job. If a new job is found quickly, the unspent balance in the account can be kept as a "reemployment bonus."

The President's proposals support investment in three ways: ending the double taxation of corporate income, raising the expensing limits for small businesses, and lowering individual marginal tax rates (which are the relevant tax rates for small businesses that pass through their income to their owners). Ending the double taxation of corporate income will make corporate equities more attractive to investors and lower the implicit cost that firms pay for equity-financed investment. As an example, the cost of capital for equity-financed equipment investment in the corporate sector would fall by more than 10 percent. For investment in structures – the weakest part of the investment outlook today – the decline in the cost of corporate equity capital would be more than one-third. For equipment investment, this decline in the cost of capital is equivalent to an investment tax credit of four to seven percent.

Accelerating the tax relief that has already been enacted will support household consumption by putting more money in the pockets of consumers this year—when it is needed most. The Treasury estimates that calendar-year tax liabilities will be reduced by almost $100 billion in 2003, with around $52 billion infused into the economy in 2003. Moreover, acceleration of the marginal tax reductions in the 2001 tax cut is likely to result in significant spending increases, because the acceleration is done in the context of long-term tax relief. In contrast, tax policy based on temporary changes to tax rates, or one-time tax rebates, would be expected to have much smaller effects on spending and thus provide less near-term support for the economy.

Macroeconomic Impacts of the President's Proposals

Enacting the President's proposal would provide important near-term support for the recovery and have a significant effect on the rate of long-term economic growth. The discussion and table that follow provide projections of the effect of the proposal as a whole on real GDP growth, employment growth and the unemployment rate, and the federal budget. To be cautious in forecasting the effects of the proposal, the projections were made using several assumptions that would be expected to moderate the expansionary effect of the package:

- No supply-side effects on effort and efficiency. The lower marginal income tax rates and other provisions of the proposal are assumed not to affect labor supply.

- No stock market effect of the dividend tax exclusion or basis adjustment for retained earnings. Ending the double-taxation of corporate income (dividends and retained earnings) would be expected to directly increase equity prices even leaving aside the effects of higher growth. CEA projections, however, consider only the effects of higher growth on the stock market, not the direct effects of the dividend tax cut on stock prices.

- The proposal takes effect in July, with no effect on the economy until the third quarter.

Indeed, the absence of supply-side effects means that the model forecasts are most useful over only the first few years of the projection period, since after perhaps two years the increased efficiency effects of lower tax rates would be expected to provide additional impetus to growth that is not captured by the model framework. The stock market effects of the corporate income tax relief might have important near-terms effects on demand, and through capital gains, on fiscal revenues. The assumptions in our model thus would lead to a conservative assessment of both the near-term and medium-run effects of the proposal on the economy.

Assuming that the package is enacted by mid-year, the projected effects on the economy would be as follows:

Output

Measured from the end of 2002 to the end of 2003 (fourth quarter to fourth quarter over the course of 2003), GDP growth would be 1.0 percentage point higher as a result of the proposal than would have been the case absent the proposal. Average annual GDP growth measured year-over-year would be 0.4 percentage points higher in 2003 as a result of the package. The difference between the fourth quarter to fourth quarter figure and the year-over-year figure reflects in large part the conservative assumption that the package will have no effect on the economy for the first two quarters of 2003. GDP growth over 2004 would be 0.8 percentage points higher measured fourth quarter to fourth quarter as a result of the package and 1.1

percentage points higher on a year-over-year basis. Over the five-year period from 2003 through 2007, GDP growth would be 0.2 percentage points higher on average per year as a result of the proposal.

Employment

Stronger GDP growth would lead to an estimated 510,000 new jobs expected to be created as a result of the proposal over the course of 2003. Another 891,000 new jobs would be created in 2004. On average, the level of employment in 2003 would be 192,000 higher than without the proposal and 900,000 higher in 2004 than in 2003. As with GDP, the much smaller year-over-year figure in 2003 compared to the fourth quarter to fourth quarter figure reflects the conservative assumption that the package creates zero new jobs in the first half of 2003. This means that the average change in employment over the entire year includes two quarters in which the proposal has not taken effect and thus is projected to create no new jobs. To show this graphically, the difference between year-average and fourth quarter to fourth quarter employment growth is depicted in the chart at the end of this paper.

On average over end-2002 to end-2007, job creation as a result of the package would be 140,000 higher than otherwise. This indicates that the proposal would bring forward a good deal of the job creation that would otherwise have occurred in 2005 and beyond (and add some as well). As noted above, the statistical model used for the projections does not include any supply-side effects under which lower tax rates would be expected to boost labor supply and further improve job creation. Corporate income tax relief would likewise be expected to lead to positive supply-side effects through improved allocation of capital across the economy and thus higher growth and job creation—again, however, this is not reflected in the numerical projections.

Federal Budget

The table includes two estimates of the impact of the President's proposals on the Federal budget. The first estimate follows conventional budget scoring and assumes that the overall level of GDP would be unchanged by the policy. The second estimate incorporates the impact of faster economic growth on overall Federal receipts. This latter figure assumes only that the faster growth resulting from the package leads to higher revenues—in all cases, it is still assumed that there is no supply-side effect of the proposal on labor supply.

The President's Proposals and the Economy

Impact of President's Proposals:	2003	2004	2003-2007
Faster Real GDP Growth			
(Q4 to Q4, percentage points)	1.0	0.8	0.2*
(Yr avg to Yr avg. percentage points)	0.4	1.1	0.2*
Additional Employment Growth			
(Q4 to Q4)	510,000	891,000	140,000*
(Year avg to Year avg)	192,000	900,000	170,000*
Lower Unemployment Rate			
(Q4 level, percentage points)	-0.3	-0.8	-0.5*
(Annual average, percentage points)	-0.1	-0.6	-0.5*
Change in Fiscal Balance; No Impact of Faster Growth ($ Billions, fiscal year)	-33	-113	-359+
Change in Fiscal Balance; With Impact of Faster Growth /1 ($ Billions, fiscal year)	-31	-82	-166+

*Average, 2003-2007.
+Total, 2003-2007.
/1 Excludes change in debt service.

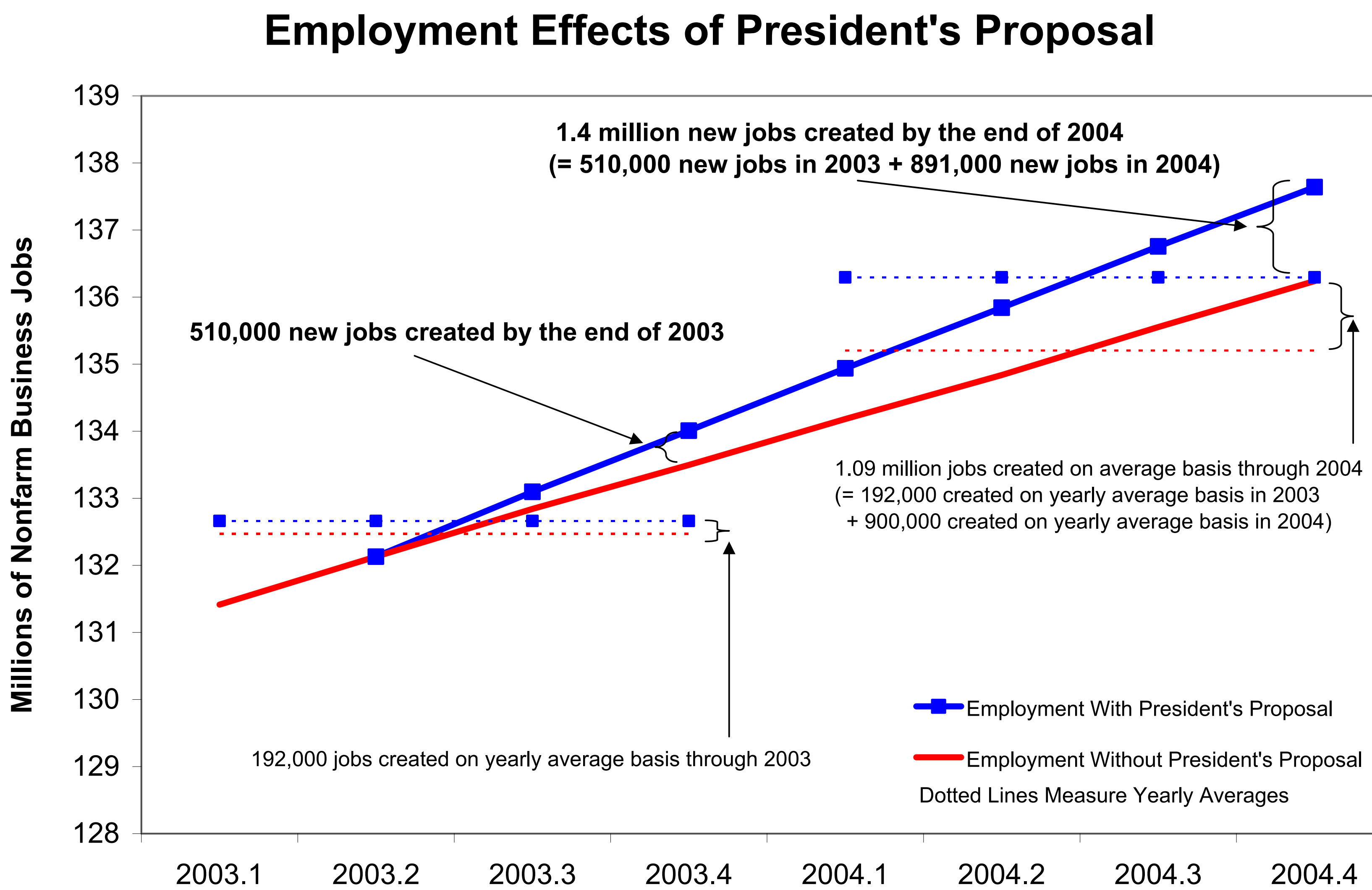
Modeling Details

The particular values of the numerical estimates presented reflect judgments regarding the implementation of the proposals. As noted above, the assumption is made that the policies are enacted and begin to affect the economy only at the beginning of the third quarter of 2003.

Many commentators have argued that eliminating the double taxation of dividends would provide a substantial boost to stock prices, perhaps raising consumption spending and adding to the short-term support for the economy. In the interests of being conservative in the analysis, however, CEA has assumed that the proposals have no direct impact on equity values.

Another important assumption is that the numerical estimates discussed above assume no changes in the stance of monetary policy. Although the exact path of future policies cannot be forecast, the President's proposals will be most valuable in the event that downside risk scenarios come to pass, which are also circumstances in which it is least likely that the effects of the policy would face offsetting interest rate movements. To the extent, however, that this fiscal insurance proves unnecessary, any potential tightening of monetary policy would partly offset the impacts shown below.

Finally, when computing the impact of faster growth on Federal budget receipts, CEA followed the historical evidence and assumed that a $1 rise in real GDP generates 19 cents of Federal revenue. In contrast, to the extent that GDP rises strictly due to higher prices (with unchanged real output), only 15 additional cents are received in nominal Federal revenues for each $1 increase in nominal GDP. This calculation is meant to be illustrative, and not necessarily reflect the view of the CEA or the Administration as to the merits of such an exercise for budget policy.



Employment Effects of President's Proposal
Millions of Nonfarm Business Jobs
139
138
137
136
135
134
133
132
131
130
129
128
2003.1
2003.2
2003.3
2003.4
2004.1
2004.2
2004.3
2004.4
1.4 million new jobs created by the end of 2004
(= 510,000 new jobs in 2003 + 891,000 new jobs in 2004)
510,000 new jobs created by the end of 2003
1.09 million jobs created on average basis through 2004
(= 192,000 created on yearly average basis in 2003
+ 900,000 created on yearly average basis in 2004)
192,000 jobs created on yearly average basis through 2003
Employment With President's Proposal
Employment Without President's Proposal
Dotted Lines Measure Yearly Averages