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CONGRESSIONAL TESTIMONY

Testimony of William W. Beach
Before the Committee on the Budget
of the U.S. House of Representatives

Congressional Hearing on

Economic Recovery: Options and Challenges

October 20, 2008

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Economic Recovery: Options and Challenges

The stock market turmoil that has captured everyone's attention is rooted in the ongoing crisis in credit markets and aggravated by the slowdown in general economic activity that stems from the ills of the financial sector. It is all the more spectacular by the extraordinary highs and lows that equity markets are recording. It almost seems that the only thing truly predictable about today's investment markets is just how unpredictable they have become.

Yet, the current situation on Wall Street and in bourses all around the world is not altogether new territory. We have seen amazing changes in stock market indexes before, and we have seen recovery in each instance. What is new to everyone except the very few who can remember market activity during the early 1930s is the high level of risk aversion that surrounds virtually every transaction. The LIBOR/Fed funds spread, a reliable measure of risk, has reached record levels in the past four weeks; and the Federal Reserve lost all control of their Fed funds target rate in the middle of September and has failed so far to recapture it. (See Figures 1, 2 and 3 attached). Despite some of the boldest moves ever made by the government of the United States to tame these fears, a high intolerance to risk continues.

We're at an odd moment in the evolution of these economic challenges: there is great hope but little evidence that the credit market fixes will work; and there is increasing concern but, again, little evidence that the financial crisis will push the general economy into a severe recession. My own sense is that we have passed into a mild recession that could become significantly worse and long-lived if Congress and other governments make wrong or ineffective policy moves. Recessions that start in credit markets last longer than those that stem from shocks to aggregate demand or supply. This one looks like it could be with us for a long while unless we do highly effective things to reduce its impact.

There also is an increasing awareness that the roots of the current crisis are firmly planted in public policy mistakes, which includes excessive liquidity produced by decisions by the Federal Reserve. The engaged public appears to understand that staunching the current flow of bad economic news requires that the root causes of this crisis be dealt with. Congress and the past two administrations bear responsibility for expanding the spectrum of home mortgages into segments of the population that were not ready for the financial responsibilities of mortgage credit. The Fed bears responsibility for fueling the feverish pace of speculation surrounding mortgages, and regulatory bodies must own up to their failure to rein in these market excesses.

Congress also finds itself at the center of debate over how best to respond to the deepening economic slowdown. Indeed, there is widespread expectation that the House and Senate will send the President legislation very soon to stimulate the economy. Many who find themselves out of work or have seen their incomes or businesses decline doubtless look forward to congressional action. The question now is, what should Congress do?

As I will argue later in my testimony, Congress obviously should do nothing to harm the economy; it should let the Federal Reserve lead the effort to stabilize economic activity; and it should keep its focus on crafting long-term, pro-growth economic policy. Most importantly, Congress should make no change to basic policies that would signal increases in risk either through raising taxes or through increasing burdensome regulations. It also should be extremely wary of any legislation that could in any way be interpreted as America withdrawing from international product or capital markets. Congress can ill afford to repeat the awesome errors of its predecessor in the early days of the Great Depression and retreat from the world economic stage.

Congress should take this moment of slow growth to do what it does best: set broad economic policy. In this instance, Congress should concentrate on signaling to investors and workers alike that its principal focus will be on improving pro-growth economic policy, mainly in the areas of tax, regulatory, and spending policies. Serious work by the Congress in these areas will create greater predictability for investors and business owners and assure workers that they will have a better chance of improving their wages through increased productivity. Efforts to enhance the long run may very well have immediate, short-run benefits as economic decision makers reduce the risk premium they place on starting new businesses or expanding existing enterprises.

I recommend that Congress address economic policies in three interrelated areas, all of which affect near- and long-term economic performance: (1) tax policy, (2) energy policy, and (3) long-term spending.

Nearly every significant general slowdown in economic activity is a good time for congressional policymakers to ask: Are we doing everything we can to support long-term economic growth? That is, slowdowns are good times to get back to policy fundamentals and make certain that everything Congress can do to allow the economy to grow has been done.

I am convinced the Congress is not the best policymaking body for addressing the short-run challenges of the economy. That role is better played by the Federal Reserve System. So much of what Congress does is tied to the budget and appropriation processes, which take time to reach legislative results. Moreover, Members of Congress frequently do not have the time or background for keeping up with financial markets, the ebb and flow of economic data, and the actions of economic institutions the way the Fed does, or even as the economic agencies of federal and state governments do. These institutional factors explain why congressional action often occurs after the need for action has expired and why the actions it takes often are not as targeted as they need to be.

However, there are areas of economic policy where congressional action can be timely and targeted, though it may not intend to be short-range in focus at all. Those areas involve the reduction of investment risk.

Investors are driven, in general, by comparative rates of return when making investment decisions between various opportunities. If two business opportunities are possible but one has a better rate of return than the other, then the investor will go with the superior opportunity—the one with the higher rate of return. Suppose, though, that outside factors intervene (a flood, war, regulatory changes) and this otherwise superior investment now carries more risk than the inferior one. The investor discounts the rates of return for the greater amount of risk, and if the rate of return on the first opportunity is still superior, the investor goes with that same opportunity. If, on the other hand, the risk is too great to go with the otherwise superior opportunity, the investor may take the more cautious approach of avoiding risk and placing funds in the opportunity with the otherwise lower rate of return.

Tax Policy Changes

What can increase risk? Many factors, of course, but public policy commonly looms large. Tax increases, especially if they land on capital, increase the cost of capital and lower investment returns. When investors are uncertain about whether taxes will go up or stay the same, they still can act as though taxes have risen if they judge the risk of an increase to be nearly equal to an actual increase. And rising uncertainty can have the effect of driving down investments in riskier undertakings.

Make the tax reductions of 2001 and 2003 permanent: Thus, among the first things Congress can do to address the current slowdown is to pronounce definitively on the tax increases scheduled for 2009 and 2011. There are projects, new businesses, and expansions of existing businesses that would be undertaken today if Congress signaled that taxes would be lower in three years. Since nearly all major capital undertakings last beyond this three-year period, it is likely that making all or most of the Bush tax reductions permanent would stimulate economic activity today as well as in 2011.

I am probably not the only one here today who knows of businesses that are preparing now for higher taxes in 20ll. They are preparing themselves by reducing their riskier projects and providing for stronger cash flows in 2010. It is altogether possible that there are projects being cancelled today that would otherwise go forward if taxes were not scheduled to rise in 2011. At times like the present, the speech of policymakers is as important as the policy actions they take. The decision makers in business and investment are watching Washington closely to discern the direction Congress will take in responding to this crisis. If that direction includes tax increases, then investors will find more favorable economies to support and business owners will, as much as they can, locate their expanded activities in places with more favorable tax regimes.

Thus, Congress should signal today what it plans to do on taxes in two or three years. For my part, I urge the Congress to make permanent the key provisions of the 2001 and 2003 tax law changes. Maintaining lower tax rates on labor and capital income will encourage both labor and capital to work harder now when we need that greater activity.

Accelerated depreciation: In addition, we know from past experience that accelerating the tax depreciation of capital equipment and buildings or one-year expensing of business purchases that otherwise would be depreciated over a longer period of time for tax purposes can help during periods of slow growth. This was certainly the record in the last slump.[1]

Taxes on capital gains and dividends: We also have recent experience with reducing the tax rate on long-term capital gains and on dividend income. If Congress were to reduce these tax rates by 50 percent for the next two years, the cost of capital to businesses would fall and investment stability would be enhanced. Indeed, if Congress were to approve a temporary zero

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[1] Matthew Knittel, "Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002–2004," U.S. Department of the Treasury, Office of Tax Analysis, *Working Paper* No. 98, May 2007, Office of Tax Analysis, U.S. Department of Treasury.

capital gains tax rate on new stock issues, troubled banks could raise the more of the capital they desperately need without having to go to the Treasury Department.

Lower the corporate profits tax: In one area of fundamental tax policy there now is nearly universal agreement: our federal business taxes are far too high. The tax rate on corporate profits is the second highest in the world. Why is it not the firm policy of the government of this country to make certain that the corporate profits tax is always below the average corporate income tax of other industrialized countries? Such a policy would enhance our competitive standing world wide and significantly reduce the incentive for U.S. firms to relocate to lower tax countries.

The current high rate affects the location decisions of businesses that end each tax year with taxable income and every business decision by taxable and non-taxable corporations who estimate the costs of buying new equipment and expanding operations. Congress should follow the lead of its Ways and Means Chairman and decrease the income tax on corporations. In fact, it should dramatically drop that rate.

If Congress were to make the tax reductions of 2001 and 2003 permanent <u>and</u> lower the corporate profits tax from 35 to 25 percent, I estimate the following economic effects would ensure:

- **More jobs**: By making the 2001 and 2003 tax reductions permanent and reducing the corporate profits tax by 1000 basis point, an annual average of 2.1 million more jobs are created. Indeed, 3.4 million jobs above a current law baseline are created in 2018 by newly energetic businesses.
- **Overall economic activity more vigorous**: These tax moves dramatically increase the level of national output. The growth rate of the economy increases a full half percentage point in 2011 and 2012, when taxes will otherwise increase under current law. The annualized growth rate jumps by .3 of a percent, and Gross Domestic Product averages $284 billion more over a 10-year forecast window than would prevail under current law. By 2018, GDP is $321 billion higher.
- **More after-tax household spending**: These tax changes dramatically improve household income, partly because the economy is so much better and partly because the average tax burden falls. The average household would have $5,138 dollars more to spend or save after paying their taxes. By 2018, this amount is $9,750 (after subtracting inflation).

Do not depend on demand-side stimulus: Demand-side stimulus (tax rebates, the child tax credit, and the 10 percent tax bracket) do little to change the course of the sluggish economy. Certainly for tax rebates, we have just passed through a laboratory experiment of sorts. President Bush signed legislation earlier this year that gave each taxpayer a $600 tax rebate ($1,200 for married taxpayers). Congress hoped that these rebates would stimulate consumption and prevent the economy from falling into a recession. While the jury is still out on this experiment, initial and supporting evidence for this view looks very thin.

More than likely, the tax rebate of 2008 will join those of 2001 in falling well below expectations as a way to stimulate the economy or move it from a prolonged sluggish growth trend. Indeed, the contraction in investment and thus job creation did not begin to improve until after the 30 percent partial expensing in the 2002 act and the 50 percent partial expensing in the 2003 act, which also cut the tax rates on dividend and capital gain income. Congress has enacted depreciation and expensing stimulus plans under Republican and Democrat majorities.

Energy Policy

Rapidly increasing prices for gasoline and petroleum based energy generally slowed the economy, helped bring on our current recession, and their effects continue to impede job and income growth. If Congress acts to expand energy supplies, forward looking prices will fall and economic activity will shed off the drag that stems from this sector.

Let me illustrate. Economists working with me in the Center for Data Analysis at Heritage estimated the economic effects of a $2.00 increase in retail unleaded gasoline.[2] We have just experienced such an increase over the past 14 months. We found that

- Total employment falls by 586,000 jobs.
- After-tax personal income falls by $532 billion.
- Personal consumption expenditures fall by $400 billion, and
- Significant personal savings would be spent to pay for the increased cost of gasoline.

These national level results reflect the economic effects of price changes. That is, disposable income falls because the economy slows below its potential. In addition, households have to spend more in gasoline.

We looked at the economic effects on three types of households. Let me describe the effects on one of these: a married household with two children under the age of 17. For this household, disposable income falls by $1,085; purchases of goods and services falls by $719; and $792 is taken out of personal savings just to pay the gasoline bill.

Some analysts argue that gasoline consumers can adapt to higher prices by changing their driving patterns and their automobiles. However, new research by Jonathan Hughes, Christopher Knittel, and Daniel Sperling (all from the University of California-Davis) shows that families today have little opportunity to quickly adapt to higher prices. Most working families have two income earners who commute by automobile to work. They live in suburbs away from mass transit opportunities. Their children have extensive after-school activities to which they are transported more often than not in an SUV. Today's short-term price and income elasticities are a full ten times smaller than those estimated using data from 20 years ago.[3]

These lower elasticities mean that consumers have a much harder time adapting to gasoline price shocks today than two decades ago. Pretty much all they can do is reduce their consumption on other items and take funds out of savings to pay for the higher priced gas. Doing so, of course, slows the economy and makes everyone else worse off.

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[2] See Karen A. Campbell, "How Rising Gas Prices Hurt American Households," Heritage Foundation *Backgrounder*, No. 2162, July 14, 2008. A copy of this report is attached to this testimony as Appendix 1.
[3] See Johanthan E. Hughes, Christopher r. Knittel, and Daniel Sperling, "Evidence of a shift in the Short-Run elasticity of Gasoline Demand," National Bureau of Economic Research *Working Paper*, w12530 (September, 2006).

There are many economic problems facing Congress, from slowing global economic activity to persistently bad news from our financial sector. Congress can act on some of the economic fronts before it, but its ability to affect the nation's economic future is limited. On energy, however, its actions to increase supplies in the short and long run could do some good, particularly for workers looking for jobs and families hoping to keep their children in violin lessons and little league baseball.

I am a free trader who believes imports are central to our economic vitality and future economic strength. However, our heavy reliance on foreign oil producers (imported oil now constitutes over 60 percent of our daily petroleum demand) has made us subject to price variations due to supply disruptions, supply extortion, and booming world demand. I believe that increasing the domestic production of petroleum and refined oil products would have a positive effect on our domestic economy, largely through more jobs and income.

In another study prepared by economists in my Center, we asked what would be the economic effects of increasing domestic production of petroleum by 10 percent. The U.S. currently consumes 20 million barrels per day, of which around 65 percent come from foreign sources. If domestically sourced petroleum increased by 2 million barrels per day, what would be the economic effects.

Our analysis indicates that such an increase would

- Expand the nation's output as measured by the Gross Domestic Product by $164 billion.
- Increase employment by 270,000 jobs.

Congress exercises enormous authority over petroleum mining, largely through its regulation of off-shore and federal land oil reserves. Authorizing more oil mining in these reserves today would begin to wean the U.S. from the economically harmful reliance on so much foreign petroleum.

One of the more tragic features of recent energy policy actions by Congress is how often it has failed to increase access to energy resources on the grounds that doing so would not have any effect on supply or price for years. While possibly correct from an engineering standpoint, this excuse for inaction makes no sense economically. If Congress were to announce greater access to proved reserves, mining activity would immediately begin, capital and talent would leave other parts of the world and travel to the United States, forward pricing markets would feel the downward pressure on prices that impending supply increases make, and ordinary Americans would not discount their own economic futures as much as they do today.

Spending Policy

Increase confidence in the U.S. economy by addressing long-term spending challenges. While the attention of most policymakers will be on immediate responses to the current slowdown, everyone should attend to a factor that's increasingly important to confidence in the U.S. economy: the seeming unwillingness of Congress to seriously address the enormous financial challenges from entitlement spending. Many investors and organizations that play key roles in the future of the U.S. economy are worried about long-term growth given the fiscal challenges posed by Social Security's and Medicare's unfunded liabilities. The *Financial Times* recently reported that the lead analyst for the U.S. at Moody's warned that the credit rating agency would downgrade U.S. treasury government debt if action was not soon taken to fix entitlements.

Thus, at a time when the economy is slowing and the speech as well as the actions of Congress can affect economic activity, policymakers should take concrete steps that will announce their intention to address unfunded liabilities in these important programs. While reforms in these programs may be beyond what this Congress can do, it is possible to signal change by reforming the budget rules.

Currently, the federal budget functions as a pay-as-you-go system, with a very limited forecast of obligations and supporting revenues. We just do not see in the official budget what may happen over the next 30 years. The five and ten-year budget windows do not permit Members or the general public to sense the obligations that are coming beyond that ten-year time horizon.

A good first step in addressing the long-term entitlement obligations of the United States would be to show these obligations in the annual budget. This could be done by amending the budget process rules to include a present-value measure of long-term entitlements. Such a measure would express in the annual budget the current dollar amount needed today to fund future obligations. Such a measure has been endorsed by a number of accounting professionals, including the Federal Accounting Standards Advisory Board.

A solid second step would be to convert retirement entitlements into 30-year budgeted discretionary programs. Such a move recognizes that mandatory retirement funding programs for millionaires that crowd out discretionary spending programs for homeless war veterans make no sense at all. If we are to contain entitlement spending and reform the programs driving those outlays, then a paradigm shift likely will be required. Recognizing Social Security and Medicare as discretionary programs helps to force attention on changes that will assure their survival well into the 21st century.[4]

[4] See Stuart M. Butler, "Solutions to Our Long-Term Fiscal Challenges," Testimony before the Committee on the Budget, United States Senate, January 31, 2007.

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