Testimony on:
Made in America: Innovations in Job Creation and Economic Growth

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March 3, 2011

Introduction

Chairman Bono Mack, Vice-Chairman Blackburn, and Ranking Member Butterfield thank you for the privilege of appearing before the Committee today. In this short statement, I wish to make the following points:

- The U.S. workers and economy as a whole will benefit from pro-growth policies;
- Pro-growth policies are distinct from the notion of "stimulus" that has been prominent in the recent debate; and
- Central aspects of a pro-jobs and growth agenda are controlling federal spending growth, improved tax policy, enhanced global trade, and a lighter regulatory burden.

Let me discuss each in turn.

The Need for Pro-Growth Policy

According to the National Bureau of Economic Research the recession began in December 2007. Their data show that there were 142.0 million jobs in December of 2007 – the average of payroll and household survey data. In June 2009, NBER's date for the end of the recession, the same method showed 135.3 million jobs, for a total job loss of 6.7 million attributed to the recession. These numbers are quite close to those using the Bureau of Labor Statistics non-farm payroll data, which showed a loss of 6.8 million.

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* The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I am grateful to Sam Batkins, Ike Brannon, Cameron Smith and Matt Thoman for assistance.

There are glimmers of promise. Since December 2009, 945,000 payroll employment jobs have been added. However at the same time, there are 14.5 million unemployed persons in the economy and many more discouraged workers. Since the start of the recession the labor force has fallen by nearly 500,000.

For these reasons, the current unemployment rate of 9.0 percent likely understates the real duress. Using the BLS alternative unemployment rate (U-6), one finds that unemployed, underutilized and discouraged workers are 16.7 percent of the total. As evidence of the difficulties, the number of long-term unemployed (27 weeks or more) is currently 6.4 million and accounts for 44.3 percent of all unemployed persons.

These data reflect the fact that the U.S. has suffered a deep recession and is growing slowly. Over the course of the past several years, Administrations and Congresses have engaged in a number of counter-cyclical fiscal measures ("stimulus"): checks to households (the Economic Stimulus Act of 2008), the gargantuan stimulus bill in 2009 (American Recovery and Reinvestment Act), "cash for clunkers" (the Car Allowance Rebate System), and tax credits for homebuyers (the Federal Housing Tax Credit). As this Committee is well aware there is an ongoing debate regarding the effectiveness of these measures in mitigating the natural course of the business cycle downturn, but I tend to be skeptical of claims of large-scale effectiveness.

Regardless of the ultimate resolution of that debate, I believe it would be a mistake for policymakers to evaluate future policy from that perspective. The U.S. economy *is* growing, albeit slowly, not declining. Gross Domestic Product (GDP) has been rising for six consecutive quarters and employment is up from its trough in December 2009. There is substantial and widespread evidence of an ongoing economic expansion. Accordingly, this is <u>not</u> the time for counter-cyclical "stimulus".

The pace of expansion remains solid and unspectacular averaging under 3 percent annual growth. In many ways this is not surprising. As documented in Rogoff and Reinhart (2009), economic expansions in the aftermath of severe financial crises tend to be more modest and drawn out than recovery from a conventional recession.[1] Nevertheless, at this juncture it is imperative that policy be focused on generating the maximum possible pace of economic growth. More rapid growth is essential to the labor market futures of the millions of Americans without work. More rapid growth is essential to minimizing the difficulty of slowing the explosion of federal debt to a sustainable pace. More rapid growth will generate the resources needed to meet our obligation to provide a standard of living to the next generation that exceeds the one this generation inherited.

Drivers of Economic Growth

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[1] See *This Time Is Different: Eight Centuries of Financial Folly*, by Carmen M. Reinhart and Kenneth Rogoff, 2009.

Policies focused on more rapid economic growth are the most important priority at this time. In light of this, it is useful to reflect on the four basic sources of growth in final demand for GDP: households, businesses, governments, and international partners.

Households are caught in a double bind of badly damaged balance sheets and weak income growth. As is well known, the collapse of the U.S. housing bubble left many households in mortgage distress, and more broadly diminished the net worth of the household sector. In addition, the financial crisis itself destroyed additional household wealth with the result that household net worth is now $9 trillion below where it stood in 2007. The expansion thus far has yielded modest income growth.

It would be unrealistic, or even unwise, to expect households to be a robust source of final demand growth. Instead, the best course for households would be to repair their damaged balance sheets as quickly as possible. Policies that support the ability of households to do so while otherwise maintaining their consumption patterns will be the most beneficial. There is little that one-time "stimulus" in the form of tax cuts or transfers contribute to these goals.

Similarly, federal and sub-federal governments face enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. Consider the federal budget. Over the next ten years, according to the Congressional Budget Office's (CBO's) analysis of the President's Budgetary Proposals for Fiscal Year 2011, the deficit will never fall below $700 billion. Ten years from now, in 2020, the deficit will be 5.6 percent of GDP, roughly $1.3 trillion, of which over $900 billion will be devoted to servicing debt on previous borrowing.

The budget outlook is not the result of a shortfall of revenues. Using the 2011 Budget the CBO projects that over the next decade the economy will fully recover and revenues in 2020 will be 19.6 percent of GDP – over $300 billion more than the historic norm of 18 percent. Instead, the problem is spending. Federal outlays in 2020 are expected to be 25.2 percent of GDP – about $1.2 trillion higher than the 20 percent that has been business as usual in the postwar era.

As a result of the spending binge, in 2020 public debt will have more than doubled from its 2008 level to 90 percent of GDP and will continue its upward trajectory. Traditionally, a debt-to-GDP ratio of 90 percent or more is associated with the risk of a sovereign debt crisis. Indeed, there are warning signs even before the debt rises to those levels.

The President has now released his budgetary proposals for Fiscal Year 2012. While CBO has yet to have the opportunity to provide a non-partisan look at their implications, my reading of the budget is that it is simply a repeat of last year's dismal plan.

The fiscal future outlined above represents a direct impediment to job creation and growth. The United States is courting downgrade as a sovereign borrower and a commensurate increase in borrowing costs. In a world characterized by financial market volatility stemming from Ireland, Greece, Portugal, and other locations this raises the possibility that the United States could find itself facing a financial crisis. Any sharp rise in interest rates would have dramatically negative economic impacts; even worse an actual liquidity panic would replicate (or worse) the experience of the fall of 2008.

Some suggest that we can stave off such a crisis by raising additional revenue. Ultimately, this approach is likely to fail as the potential spending plans exceed any reasonable ability for the U.S. to finance via higher taxes. No tax regime since World War II has come close to raising 25 percent of GDP, during a period that has seen an incredible variety of tax rates.

Pro-Growth Policies Versus Stimulus

The foundation of economic growth is the act of foregoing current consumption in order to save; using those savings to invest in innovation, skills, new plant and equipment, and new technologies; and thus expanding the size of the economic pie for every American. A pro-growth approach to policy design emphasizes strong incentives to save, protection of the returns to innovation and technological advance, and minimal interference in the ability to access markets, hire workers, and deploy new investments.

In contrast, conventional Keynesian counter-cyclical policy – "stimulus" in political parlance – emphasizes policies to induce households to spend or directly takes this responsibility on the federal budget. These policies emphasize consumption at the expense of saving, are oriented toward propping up legacy firms and activities at the expense of innovation, and de-emphasize the role for the private sector.

The two approaches differ in another important way. The heart of stimulus – spending increases and temporary tax cuts – are activities that should be reversed over the longer term. History suggests that Congresses and Administrations have been very good at "doing" stimulus, and very poor at "undoing" it when needed. In contrast, pro-growth policies are permanent signals to households, entrepreneurs, investors, and innovators. One virtue of making pro-growth policy changes at a time of weak economic performance is that there is "no regrets" – it is simply accelerating a policy that one would like to pursue in any event.

A Pro-Growth Policy Agenda

Controlling Federal Spending. The federal government needs to reduce spending growth, and control its debt. No sensible growth strategy can be built around greater federal spending, or greater government spending more generally. The projections of sharp growth in federal spending, deficits and debt raises the prospect of higher interest rates, higher taxes, or both. This constitutes a serious impediment to confidence among businesses and entrepreneurs to locate in the United States and inhibits those that do from being willing to grow, expand and hire.

Accordingly, the top issue for a pro-growth policy agenda to create jobs in America is to control federal spending. The House of Representatives has taken an important first step in doing so with the passage of H.R. 1. Unfortunately, recent reports have suggested that it is instead a <u>threat</u> to U.S. economic growth. I concur with Federal Reserve Chairman Ben Bernanke that these analyses are mistaken.

The first thing to note is that while Members are aware that a reduction of $61 billion in <u>budget authority</u> does <u>not</u> translate into an immediate $61 billion cut in <u>outlays</u>, many analysts appear to not understand these budgetary facts. Indeed, on average, a $1 cut would translate into only 52 cents during the current fiscal year.

In gauging the <u>maximum</u> possible growth impact, one could assume that a full $32 billion in reduced spending would occur in Fiscal 2011 (i.e., before September 30) even though there are only 7 months left. For simplicity, suppose that outlays fall by $16 billion in the 2nd quarter, $16 billion in the 3rd quarter, and – to really gauge the upper bound – another $16 billion in the 4th quarter of calendar 2011.

What happens? If one thought that the growth rate in 2011 would be 3.0 percent, it would fall to 2.7 percent. That is, the upper bound impact is 0.3 percentage points. Still, this continues to <u>overstate</u> the likely impact because:

- The calculation assumes full dollar-for-dollar reduction in GDP as spending declines. This is too large, especially because;
- Not all outlay reductions are actual cuts in the purchases of goods and services to contribute to measured GDP. Instead, some are transfers payments to states or individuals that will have a more muted impact;
- Not all of the budget authority cuts are from new spending. Instead, some are rescissions of the authority for <u>spending that never occurred and might never occur</u>; and
- Most importantly this is a static calculation that assumes no beneficial offset in private sector spending because of the improved budget outlook and prospect of lower future taxes and interest rates. Put differently, the criticisms <u>ignore the rationale for making these beneficial cuts to begin with: to clear the way for private sector jobs and growth</u>.

Far from being either a mistake or a muted misstep, this is a step toward exactly the right strategy. As summarized in a recent paper by Ike Brannon at the American Action Forum the research indicates that the best strategy to both grow and eliminate deficits is to keep taxes low and reduce public employee costs and transfer payments.[2]

Improved Tax Policy. With households and governments facing the task of repairing their balance sheets, America's hope for economic growth lies with business-sector spending and net exports. What's needed now is a tax policy that has incentives for businesses and entrepreneurs to locate in America and spend at a faster rate on innovation, workers, repairs, and new plants and equipment.

The place to start is the corporate income tax, which harms our international competitiveness in two important ways. First, the 35 percent rate is far too high: when combined with state-level taxes, American corporations face the highest tax rates among our developed competitors.[3] The rate should be reduced to 25 percent or lower.

Second, the United States remains the only developed country to tax corporations based on their worldwide earnings. Our competitors follow a territorial approach in which, say, a German corporation pays taxes to Germany only on its earnings in Germany, to the U.S. only on its earnings here, and so forth. If we were to adopt the territorial approach, we would place our firms on a level playing field with their competitors.

Proponents of the worldwide approach argue that because it doesn't let American firms enjoy lower taxes when they invest abroad, it gives them no incentive to send jobs overseas. Imagine two Ohio firms, they say: one invests $100 million in Ohio, the other $100 million in Brazil. The worldwide approach treats the profits on these two investments equally, wisely giving the company that invests in Brazil no advantage over its competitor.

But this line of reasoning ignores three points. First, because firms all over the world will pay lower taxes than the two Ohio companies, the likeliest outcome of the scenario is that both firms will fail, unable to compete effectively with global rivals. Second, when American multinational firms invest and expand employment abroad, they tend also to invest and expand employment in the United States. In the end, healthy, competitive firms grow and expand, while uncompetitive firms do not, meaning that our goal should be to make sure that American companies don't end up overtaxed, uncompetitive, and eventually out of business. And finally, because

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[2] See http://americanactionforum.org/news/repairing-fiscal-hole-how-and-why-spending-cuts-trump-tax-increases

[3] Some defend the high corporate tax rate by arguing that the effective corporate tax rate is much lower. This misses an important point. Every country's effective tax rate is also lower than its statutory rate. A recent study by two economists at the University of Calgary (http://www.cato.org/pubs/tbb/tbb_64.pdf)concludes that the marginal tax rate in the U.S on new investment is 34.6 percent, higher than any other country in the OECD.

the U.S. is the holdout using a worldwide approach, it is at a disadvantage as the location for the headquarters of large, global firms. As the U.S. loses the headquarters, it will lose as well the employment, research and manufacturing that typically is located nearby.

The corporate tax should be reformed further. At present, companies must depreciate their capital purchases over time. Instead, they should be allowed to deduct immediately the full cost of all investments, which would provide a dramatic incentive for spending. We should also consider phasing out the tax-deductibility of the interest that companies pay on their borrowing. Because this interest is deductible and the companies' own dividends are not, firms have an incentive to borrow excessively. Removing that incentive—making a firm's tax liability dependent not on its financial decisions but on its real economic profitability—would discourage financial engineering and focus corporations on their core mission.

A more competitive corporate-tax system would be a good start in our effort to encourage private-sector growth. But a lot of private-sector economic activity in the U.S. isn't affected by the corporate tax at all. Activity that takes place in sole proprietorships, partnerships, and other "pass-through entities"—organizations whose income is treated solely as that of their investors or owners—is instead affected by the individual income tax. Congress' Joint Committee on Taxation projects that in 2011, $1 trillion in business income will be reported on individual income-tax returns.

It's important to note that nearly half of that $1 trillion—$470 billion—will be reported on returns that face the top two income-tax rates. A conservative estimate is that more than 20 million workers would be employed by firms directly affected by those two tax rates. Tax reform should avoid higher marginal tax rates in favor of lower rates and a broader base. Marginal tax rates and the taxation of dividends and capital gains directly affect companies' decisions about innovation, investment, and savings.

Americans—from homeowners to small businesspeople to the millions of unemployed—are in desperate need of faster and prolonged economic growth. Congress should therefore evaluate tax proposals based on whether they're likely to trigger and support that growth. Tax policy can play a key role in spurring an economic recovery—but not without sustained reform of both the corporate and individual income-tax systems.

Enhanced Global Trade. It will not be news to the members of this committee, who have jurisdiction over trade issues, that the past four years have been ones of virtual stagnation on U.S. involvement in global trade – a far cry from the postwar tradition of U.S. leadership on reducing barriers to multi-lateral trade. The Doha Round of multilateral trade liberalization is moribund, in no small part due to the absence of U.S. leadership. No new bilateral trade bills have been negotiated or passed into law, and the three holdovers from the previous administration—Panama, Columbia, and South Korea—await an uncertain fate, if and when they are submitted to the Congress.

While the U.S. has sat on the sidelines, the rest of the world has not. A plethora of bilateral and multilateral free-trade-agreements have been passed over the past four years. South America, the Pacific island countries, Africa, and Asia have all seen robust new agreements expanding trade in their regions. In addition, the European Union has been enthusiastically seeking to expand their economic ties with other developed countries and free trade regions as well, especially in Asia. Europe has taken the sensible attitude, backed by a wealth of economic research, that expanding markets is a route to faster growth in anemic economies in both the near term and over the long run. The conspicuous absence of the U.S. in trade agreements – at the same time that the President has set a goal of doubling exports in the next five years – does not assist economic growth in the short run and makes it more difficult for U.S. firms to establish a market presence in new areas in the long run.

Lighter Regulatory Burden. Regulations have an unmistakable cost. It includes the direct cost by businesses having to spend to comply with the new rules (similar in concept to the dollars of tax payment) as well as the economic activity – the jobs, investment, and expansion given up as a result of the regulation (similar to the distortions produced by marginal taxes). These regulatory costs have the potential to impede growth.

Given the necessity of growth at this juncture, it is imperative that only those that generate benefits in excess of their economic and administrative costs be enacted, or remain on the books. I believe that many regulations are overly broad and cost US businesses too much money for the benefits ascribed to the regulations. Putting actual numbers on both the costs and the benefits can be a difficult task, but there is no substitute for good-faith efforts and a willingness to trim back regulatory overreach.

There is no excuse, however, for conflating what is a cost and what is a benefit of a regulation. When a regulation will force businesses to hire 100 additional workers to comply, it is a cost. Recently, in its newly-proposed regulations governing boilers and process heaters, the Administration has suggested that this is actually a "stimulative effect" that goes down as a <u>benefit</u>:

> "[I]n periods of high unemployment, an increase in labor demand due to regulation may have a stimulative effect that results in a net increase in overall employment."
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> "Regulated firms demand labor workers to operate and maintain pollution controls within those firms."

> "Increased demand for pollution control equipment and services: When a regulation requiring emission reductions is promulgated, affected sources must immediately place orders for pollution control equipment and services. Filling these orders will require a scale-up in manufacturing of pollution control equipment, performance of engineering analyses and significant expenditures for assembly and installation of such equipment. <u>These activities will be job-creating during the period before firms must comply with the rule, at which point all pollution control equipment must be installed and operating.</u>" [Emphasis added.]

This is unadulterated nonsense.

Conclusion

At this juncture, the United States needs a keen focus on enhancing the rate of economic growth. Workers and economy as a whole will benefit from pro-growth policies, which are quite distinct from the notion of "stimulus" that has been prominent in the recent debate. Finally, central aspects of a pro-jobs and growth agenda are controlling federal spending growth, improved tax policy, enhanced global trade, and a lighter regulatory burden.

I look forward to answering your questions.