BEYOND THE TAX CUT: UNLEASHING THE ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY, TECHNOLOGY,
AND ECONOMIC GROWTH

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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BEYOND THE TAX CUT: UNLEASHING THE ECONOMY

THURSDAY, MARCH 29, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
TECHNOLOGY, AND ECONOMIC GROWTH,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Peter T. King, [chairman of the subcommittee], presiding.

Present: Chairman King; Representatives Oxley, LaFalce, Shays, Grucci, Green, Ose, Paul, Fossella, Hart, C. Maloney of New York, Clay, and J. Maloney of Connecticut.

Also present: Representative Toomey.

Chairman KING. The hearing will come to order.

It is my personal pleasure to begin the first business of this new subcommittee by examining one of the most vital issues facing our country—the health of the economy.

Let me first say that I welcome the distinguished Representative, Mr. Armey, and I thank all of you for setting aside time in your schedule to share with us your economic insights.

I would also like to congratulate Mr. Kvamme on his newly appointed status as President Bush's Co-chair of the President's Council of Advisors for Science and Technology. I understand that Mr. Kvamme will have to leave early so he can get down to the White House. They do have certain priorities, so we will certainly respect that.

The importance of economic growth cannot be overstated, particularly at this point in time. There is strong fear and skepticism across the Nation as to where our economy is headed. Today, it is my hope that we will discuss the many steps necessary to put the economy back on track, starting with some tax relief.

In the interest of time we would ask that the Members limit their opening remarks today and to put them in the record. I also realize that Mr. Armey is under very serious time constraints this morning, and I agree with my distinguished Ranking Member, Mrs. Maloney, to allow only these limited remarks before Mr. Armey gives his remarks.

Again, I can't stress enough how important the subject matter is that we are covering today. We're talking about jobs, savings, education, and the list goes on.

I also want to commend President Bush for taking on this problem head on. And, as to the subcommittee, I assure you we will do all we can to ensure economic growth.

I will yield back my time and recognize the distinguished Ranking Member, a good friend from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you very much, Mr. Chairman, and I will withhold my full statement until after the Majority leader testifies.

Given that this is the first hearing of the new Domestic Monetary Policy, Technology, and Economic Growth Subcommittee, let me first welcome the Chairman, Peter King, my fellow New Yorker. I look forward to 2 interesting years of working together and I look forward to today's hearing, and particularly I am very eager to hear the Majority leader's testimony.

I yield back the balance of my time. I will submit later my opening statement.

[The prepared statement of Hon. Carolyn B. Maloney can be found on page 44 in the appendix.]

Chairman KING. I thank the Ranking Member.

And now it's my pleasure to introduce the Majority leader of the Congress, my good friend from Texas, Mr. Armey.

STATEMENT OF HON. RICHARD ARMEY, MAJORITY LEADER, U.S. HOUSE OF REPRESENTATIVES

Mr. ARMEY. Thank you, Mr. Chairman.

First of all, let me say, it's a pleasure to be invited, particularly on this subject, a subject I've studied throughout most of my adult life.

Let me begin, Mr. Chairman, by pointing out that I believe in the separate authority of the Federal Reserve Board. I believe that the proper role of the Federal Reserve is to be obsessive with inflation and I believe that the current Federal Reserve Board does their job quite well in that regard.

I do believe though that there should be a coincidence between the Federal Reserve's monetary policy and the Federal Government's fiscal policy. And that coincidence should be born out of an accurate understanding of what's going on in the economy.

The current news about the re-evaluation of our last quarter's performance and the current indications of this quarter's performance cannot be encouraging to the American people; and they are, in fact, looking to us to do something about it.

Let me just talk about what it is we can do. The clear first fact that is what we can do must almost inevitably be and almost perhaps solely be in the area of lowering taxes. The incredible tax debate that we're having right now centers around the President's tax plan. Everybody realizes and, indeed, I believe they realize also at the White House that that plan was written at another time under different economic circumstances when the Nation was in a different mood about tax reduction than what we are today.

Today, the Nation is concerned about the performance of the economy and they are anxious to have a tax reduction and they are becoming more critical with respect to the forum in which the tax reduction takes place.

And while I applaud the President's plan, the component parts of the President's plan do not, I think, find themselves constructive in the most favorable way for economic growth and to provide incentives to growth.

My recommendation is that we change the President's plan in such a way as to do what the President has said he would do, and that is the commendable part of the position he takes today, he's trying to implement what he campaigned on.

But to go a little bit further, I believe that you can see change happening now already. A few weeks ago, some of us were talking about retroactivity, and now retroactivity of the President's plan seems to have a growing following, and I indeed expect more retroactivity in the final analysis than what you've seen already in the rate reduction that we've seen.

But while it is beneficial and is certainly just to do things like eliminate the marriage penalty and eliminate death taxes, and while death taxes in particular may have some long-term growth incentives in their elimination, there are things that I think we ought to be doing in addition to the marginal rate reduction that could speak more quickly to today's more immediate concerns. And those would be in the areas of capital gains tax reduction to provide further incentive for investment. But one thing that is indisputable now by our historical experience with reducing capital gains is that it does, in fact, incentivize growth in the economy, investment is the engine of economic growth.

And, in particular, Mr. Chairman, since we see the scope of your jurisdiction in this subcommittee, relate that to high-tech world in which we live today. We are going through, in the world, driven, I think, very largely in the United States, by what I would call the "electronic revolution." We have the agricultural revolution, we had the industrial revolution, now we are in the electronic revolution and it is a magnificent phenomena.

The high-tech sector of the economy obviously shows us a change. When we had our recent concerns about the stock market, it showed up in the NASDAQ with the high-tech instruments there.

So when we look at what we can do on the investment side, we ought to be sensitive to what we can do to sustain high levels of investment in this dynamic sector of the economy, this leading sector of the economy.

Capital gains tax reductions certainly would be good for that sector of the economy as it would be for any other sector of the economy.

I think we ought to look, in particular, at some things that we might be able to do in the high-tech sector. And one of the suggestions I might offer is expensing capital for software and perhaps even consider it for hardware simply because its' rate of obsolescence is so high. My way of putting it is, that every time you have another college dropout, you have another new major innovation in the high-tech computerized sector of the economy. And that, of course, means that people who would want to implement this for the increased productivity they can have, have to recapture that cost quickly or they may not dare to do so, because it could be obsolete next year.

The other thing that I think that we have available to us is the Portmann-Cardin retirement security legislation. This expands IRA opportunities for all Americans. And certainly one of the things that it does that you can put under the item of justice is give hard-working American, stay-at-home wives, the same access to this opportunity for their retirement as wives who work outside the home. That is something that just must be done.

The affordability is very important given the nature of our economy today, especially, again, in the high-tech sector. Those folks move around like college professors and they need to take their pensions with them. So I think that's an important point.

One final thing I would like to touch on, there is, today, what I'm calling the "rebate debate." Because of the success that we have had in holding down spending and generating a surplus to the economy, we have in this current fiscal year a substantial surplus of some $70 billion. That money can be available for a tax rebate right now almost immediately. And that is not a bad thing to do.

Any time you take people's money, that is received by the Government, in a sense as a tax overcharge, you can give it back, and that would be a good thing to do. And I would be all willing to do that. But I do not think we should entertain any thought of doing that instead of a larger, more comprehensive tax reduction policy such as the President proposed leading with a rate reduction and adding some of these other growth factors.

Anybody that would suggest that, I would suggest doing what I would call "rebate and switch." And that would be a bad effort for us to entertain.

So what I would suggest on that is we take advantage of this surplus that is in this existing fiscal year to enhance what we can achieve under the President's plan. That is, perhaps, by the way to transfer some of that money to some of the out years to make the plan work more smoothly in the out years, or indeed to, in fact, increase the retroactivity for this year out of this year's money through some mechanism or indeed possibly the rebate itself.

But let us not let this opportunity for immediate rebate born out of this fiscal year's surplus detract our attention from the larger requirement of providing America with a set of new opportunities and incentives to do more in their life.

Let me put it to you finally in this way, if I were to get into a poker game with a thousand dollars and win with this thousand dollars, I would certainly celebrate that thousand dollars and I have no doubt I would spend it to stimulate the economy. But I would make no life changing decisions on that. I would like to point out, incidentally, that if I were to lose a thousand dollars, my wife would make a life changing decision.

[Laughter.]

And that is analogous to the region, certainly we will have used it productively on behalf of our families. But it provides no incentives for us to make change. As opposed to a tax plan that says, for now and into the future you will receive a greater take-home pay for your larger efforts. You will receive a greater return on your investments to reduce capital gains tax. You will be able to take a date to put into technology that might be obsolete in a year, because you can afford it at this time by expensing. Those are things that really provide people the opportunity to take the risks, the innovate, be creative, and improve technology.

We must never underestimate the impact of computerized electronic technology in our economy and the impact is precisely this. It give us growth to increase productivity and that is the only way we can have growth without carrying with it the current inflation. And that is the miracle of modern electronics in terms of economics and we ought to foster investment.

Thank you.

Chairman KING. Thank you for your testimony.

I realize that your schedule is very tight this morning, so I am going to yield my time to the Chairman of the full committee, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. And welcome, Mr. Majority Leader, to your first appearance, and hope not the last, before the new Financial Services Committee. Let me commend you for your vision in helping us create this new committee. And I think the ability to consolidate all of the financial services jurisdiction under one committee was a wise decision. And we appreciate your ideas and leadership on this.

I was driving in this morning and heard the Oakridge Boys on——

Chairman KING. Imus.

Mr. OXLEY. Imus; very good.

[Laughter.]

You probably heard the same thing. And I thought immediately of my friend from Texas and was pleased to have him here today. I'm not going to ask questions and I'm going to make my opening statement part of the record.

[The prepared statement of Hon. Michael G. Oxley can be found on page 42 in the appendix.]

I just wanted to indicate our appreciation for your appearance and your leadership on these economic issues. Everybody knows you are an economics professor, and I think once an economics professor, always an economics professor.

I remember a long time ago we were down in Oklahoma and we were saying that you became an economist, but your mother wanted you to be an accountant but you didn't have the personality——

[Laughter.]

I've always remembered that for a long time. But we do—I know your time is short and we do appreciate your appearance here and look forward to working with you on a lot of these economic issues that are so important to our country's future.

Mr. Chairman, I yield back.

Chairman KING. Thank you, Mr. Chairman.

If I might just comment. I too listened to the Oakridge Boys this morning and thought about Chairman Tauzin, who in reflection about the construction of this committee in singing their song, "it takes a lot of river to wash these tears away."

[Laughter.]

We will pass it on to the gentleman from Louisiana.

[Laughter.]

I now recognize the Ranking Member, Mrs. Maloney.

Mrs. MALONEY. And I thank the Chairman for being here and for his ideas. You have often come up with ideas that stimulate the economy. And I think everybody owes a debt to you for coming up with the idea of the base closing commission. Congress was stranded and couldn't move, and you came forward and solved that problem and moved it forward.

I want to ask a question about the alternative minimum tax. Under current law, the Joint Committee on Taxation estimates that over 20 million Americans will fall into the AMT by 2011. They also state that the Bush tax cut increases this number to 35 million—benefits of the Bush plan. The impact is especially hard on States that have State income taxes like New York, the State that the Chairman and I represent.

Just today, in the delegation meeting that we were at earlier, the Chairman of the Ways and Means for the Democrat—the Ranking Democrat Member, Mr. Rangel, circulated a letter in which he merely stated that the program merely had changed the name of tax they paid, not the size, talking about the AMT, the tax cut moving more people into it. And I just wondered what your comments were on it. Do you acknowledge this problem and do you have any plans as to how to solve it?

Mr. ARMEY. Let me first of all thank you for raising that question. This gives us another opportunity, I think, to appreciate the President's openness. Because as we begin to look at constructing the President's plan in the tax law, Chairman Thomas immediately spotted this problem. And as you can see, looking at what was done on the rate reduction bill that passed the House a couple of weeks ago to address the alternative minimum tax to mitigate against that that you will see also in the bill that we have on the floor today where we put a hold harmless provision in the bill that prevents additional people from being afflicted by the alternative minimum tax.

I think the healthy indicator that you see in both these actions by the Chairman as the mark ups come out of his committee and to the floor and the applause that he's received, the encouragement from the White House is that, yes, we are very much aware of that and we are very committed and mitigate any impact on that, even to have a renewed look at the alternative minimum tax in its total as to whether or not it's something that should be continued in tax law.

So the one, I think, very healthy thing that has come out of the President's proposal and our efforts to right it is a very—let's say, thorough-going reexamination of the minimum tax, how we can mitigate against that and, indeed, its very legitimacy. So I think Chairman—or the Ranking Member Rangel forgot to raise these issues. I think the committee is sensitive to this and I know the Administration is encouraging in that effort.

Mrs. MALONEY. Can it aid him to fix the—within the $1.6 trillion that we're considering in that?

Mr. ARMEY. It seems to me that one of the things we would have to do—I kind of laughed, I said, my mother always figured I'd be in a straightjacket some day, but I never thought it would be a $1.6 trillion straightjacket.

[Laughter.]

And one of the things that I'm encouraging everybody is, as we re-examine our opportunities, let's see the extent to which we need that extreme. We might be able to get around that, and, indeed, the alternative minimum tax provides, I think, a need that's sufficient enough so that any reasonable person that wanted it accomplished, the other thing that we can do with that tax cut—or maybe going to $1.7 or $1.8 is worth it in terms of the good things we can do. So I think we just need—outside the $1.6 million.

Mrs. MALONEY. You mentioned in here an interesting idea, I had really never heard of it before, of expensing capital for hardware, acknowledging the great impact that technology has on growing our economy. And would you expand that to parents to deduct the cost of buying computers?

When I was growing up, we had to have a pencil when we were in school. Now the kids have to have a computer.

I know that in New York a lot of our high schools and middle schools are not even wired for computers. They don't even have computers. How in the world can they get a job in this new world economy without computers? I think it's an important point that you raised about the impact of the new technology of growing our economy and the importance of recognizing it in business. I think we've got to recognize it in education. And I wonder if you have any further comments on it?

Mr. ARMEY. Well, one has to, I think, always be very careful in terms of differentiating in electronics and computers where it is, in fact, a business application and where it is a recreational application. Because recreational opportunities of the modern computerized technology are, of course, enormous; so enormous that my wife no longer calls my office "my office" she calls it "my play room" since I put a computer in there. So as parents examine that, I think we have so many efforts to try to get computers in the hands of our young people through the schools and then other efforts. I do think we need to differentiate.

If you're talking about expensing capital, whether it's in the form of what kind software or hardware, I think you need to keep that notion applied to where it is currently applied in business applications.

Mrs. MALONEY. Thank you very much.

Chairman KING. Thank you for your testimony. We realize you are to be at another meeting at 10:30. So we want to thank you. I just would like to say that the more I hear about your mother, the more I really admire her insights.

[Laughter.]

Thank you very much for your testimony today and any final statement you want to make.

Mr. ARMEY. I just want to thank you again for letting me be here. And I want to thank you all, in particular, for sparing me the tough questions that might have come from Mr. Shays.

[Laughter.]

Chairman KING. Thank you, Mr. Armey.

If the next panel will step forward.

Mr. Shays, would you like to make an opening statement?

Mr. SHAYS. No, Mr. Chairman.

Mr. Grucci.

Mr. GRUCCI. No, Mr. Chairman.

Chairman KING. Mr. Ose.

Mr. OSE. No.

Chairman KING. I recognize the Ranking Member.

Mrs. MALONEY. OK. This morning the subcommittee considers the topic, After the Tax Cut: Unleashing Economic Growth. While I plan to raise a number of issues, I must comment on tax cut stuff—actually on the floor that the Majority is proposing. They constitute some of the greatest challenges to sustaining economic growth by threatening a return to large deficits and higher interest rates.

One of the Majority's tax cuts is so large based on economic assumptions that it varied so greatly that we risk deficits if our numbers are only slightly off.

CBO, whose rosy projections are the voices for the tax cuts, indicated that its average error margin in projecting budget surpluses or deficits for fiscal year in progress has historically been about .5 percent of gross domestic product—GDP. In the current economy this would be $54 billion in 1 year. As projecting 5 years out, CBO's average error has been 3.1 percent of GEP, a sixfold increase—to borrow a Bush catch phrase this is truly "faith-based budgeting."

Second, despite the tax surplus the Federal Government is enjoying, danger lies just over the horizon. The uncertainty of the next 10 years, trumped by the uncertainty of the second ten starting in the later half of this decade as the baby boomers will begin to retire, drastically increasing our retirement commitments. Should we find ourselves facing deficits in 2008 we will truly be in a dire predicament.

Third, as we all know, the economy is slowing and the President's supposedly $1.6 trillion tax cut, which is actually closer to $2.2 trillion with interest not paid on the debt and the necessary fixes are included, is not conceived as economic stimulus, it was a campaign package that was constructed 2 years ago to appeal to Republican primary voters.

It will have little immediate impact, and in fact, 75 percent of the promised tax cuts comes in the second 5 years. The Majority may claim to want to end the marriage penalty, but as some of my Democratic colleagues have pointed out on the floor, their plan is like a tenth anniversary present.

These concerns are reflected today in an editorial that is in *The Washington Post* entitled "Tax Fraud." While I could go on about this ill-conceived tax package, let me simply say that the Democrats support tax cuts and we could easily have bipartisan consensus for an historically larger, fair, and immediate tax cut that would be supported on bipartisan basis and passed in days. Looking beyond the Majority's flawed tax cut there is a great deal Congress could do to spur economic growth. The Federal Government plays a critical role in encouraging research and development in the private sector. This is especially important to technology companies that have been the engines of economic growth, as the leader just pointed out, in the last decade.

We must also increase our commitment to the education of all of our children, especially those in public schools. I do not believe that this is accomplished through any program that we merely subsidize other schools by taking money out of the public school system.

Finally, I strongly favor, as part of a responsible tax cut plan, increasing IRAs and 401(k) contribution limits and allowing for pension catch-up contributions. These provisions increase savings and catch-up contributions can be especially beneficial to women rejoining the workplace later in life.

I believe the Congress can make major positive contributions to economic growth. My only fear that the Majority's plan commits almost all of our expected future surplus to a long-term tax cut that would do nothing for economy now and it would take away our flexibility to deal with future economic needs as they arise.

Let me just close by saying, even the economies only projected a 5-year plan and that a 10-year plan really might cause problems if there is.

I thank the Chairman.

Chairman KING. Thank you, madam.

Mr. Shays.

Mr. SHAYS. I would love to make a statement.

The economy has had a 5-year plan, but then our economy went down because it was an economy that was directed by the Federal Government. My big fear is that if we don't return some of the taxes back to the American people, we are going to start to see an economy that is more directed by the Federal Government.

I served on the Budget Committee for 10 years and during that time I became more and more convinced of the value of tax cuts. We had a President, President Kennedy, who wanted a tax cut when we had no surpluses. We had another President who wanted a tax cut when we had deficits. We have a President now who is saying we should have tax cuts when we have a surplus, and the surpluses are quite large.

In listening to the budget debate for the last 2 days, I was struck by the fact that, contrary to what my colleagues on the other side of the aisle were arguing, you know, no tax cuts pay down the debt, practically everything that came forward was just more spending. So the issue is, why would you want to continue to spend more money if we could just spend the surplus? That is where the difference is. And I would suggest with all due respect to my colleagues, the Ranking Member whom I agree with, much more than I disagree, cutting taxes a quarter of the projected surplus makes eminent sense. Trying to speed that up, I agree, would make eminent sense. But we phase it in, and if in the future we decide we do not want part of that phasing to go in, there is nothing to prevent a future Congress from saying, let's not do it.

I am eager to hear what our colleagues have to say. I'm not sure we will agree on everything, but I just learned a lot from what all four have said over the past years and I think our economy has been better for our listening to them.

So I am eager to begin this hearing and I thank you, Mr. Chairman, for conducting this hearing.

Chairman KING. Thank you Mr. Shays. I will now introduce our panel.

First, Mr. Floyd Kvamme, who we mentioned before, was appointed by the White House to the President's Council of Advisers for Science and Technology; Mr. James Glassman from American Enterprise Institute; and Dr. Martin Baily, Senior Fellow, International Institute for Economics. We are expected to have Larry Kudlow, who we presume is on the way.

Mr. Kvamme, we realize that you are going to have to leave early and we would just ask you to go on and give your testimony.

STATEMENT OF E. FLOYD KVAMME, CO-CHAIRMAN, PRESIDENT'S COUNCIL OF ADVISORS FOR SCIENCE AND TECHNOLOGY

Mr. KVAMME. Thank you.

Mr. Chairman, I am pleased and honored to have the opportunity to testify before the subcommittee on issues of tax policy in capital formation and to submit written statements. These hearings could not come at a more propitious time; weakening economic performance and a greatly divided stock market have significantly inhibited and will even erode the ability of our capital markets to allocate the necessary resources to fund growth in our economy and maintain our international competitiveness.

I am a general partner at Kleiner Perkins Caufield and Byers in Menlo Park, California; we are a high-technology venture capital firm, and in that capacity, I serve on the boards of directors of some seven high-technology companies. I also serve as Chairman of Empower America, a Washington-based issue advocacy organization; on the board of the Washington-based National Venture Capital Association and on the Executive Committee of the Technology Network, a network of about 280 high-tech firms with headquarters in California, but with members from across the country.

My testimony today, while influenced by each of these associations, represents, however, my personal view on steps that could unleash the economy.

For more detailed explanation of my testimony here, please review the written testimony I have submitted to the subcommittee.

Mr. Chairman, as you know, the venture capital industry has been a catalyst for much of our economy's remarkable and consistent growth in the past decade. What used to be a relatively small community of investors has expanded into a nationwide industry. The skills of talented entrepreneurs and managers backed by venture professionals has translated into successful investments that have greatly increased interest among the investing community in this asset class, and has provided significant returns to the pension funds, foundations, university endowments and other organizations that are our limited partners.

These investments are helping to introduce and integrate critical technological innovations that are being applied throughout the economy. According to the Federal Reserve Board, industry's application of information technology over the past decade has vastly increased labor productivity.

Today, however, we are presented with the challenging question of how to keep this level all productivity and economic growth growing.

An important first step to economic growth is already being taken. President Bush's tax relief proposal which is advancing through Congress is critically important to both the short-term and long-term growth. Reductions in marginal tax rates and the elimination of both the estate and marriage penalties will release much needed capital into the economy and lead to still greater productivity. I applaud the steps you and your colleagues have taken to enact the President's tax package.

But I urge you to consider more comprehensive tax and regulatory relief efforts focused on sustained economic growth in security. Below, I offer some specific ideas.

The number one priority of emerging growth companies is, and always has been, sufficient and efficient access to capital. Congress has taken important steps in the recent past to help in this area, most recently in 1997 when it lowered the capital gains tax rate. But our industry believes that further efforts to lower the tax rate are necessary. The U.S. investors face capital gains tax rates on both short- and long-term gains, which are among the highest in the industrial world. The U.S. long-term rate of 20 percent compares to an average of 14.8 percent overseas while top short-term rates in the U.S. compared to an average of 18.4 percent international average. Closing these differentials will significantly enhance the incentives within our country to buy, hold, and sell equity instruments for individuals and corporations.

Interestingly, if the past is any predictor of the future, every time the capital gains rate has been reduced, revenues from taxation of capital gains have increased. Thus, capital gains reductions will broaden the President's tax cut proposals while raising the after-tax return on capital, making it more attractive for people to invest in startup companies.

In contrast to this focus on capital formation, the idea of a $60 billion cash tax rebate check unconnected to more comprehensive reform aimed at temporarily bolstering consumer spending is circulated.

But as Larry Kudlow will probably point out, consumption expenditures are the strongest part of today's economy. In the current quarter, real consumer spending could, in fact, increase by 3.25 percent.

In stark contrast stands investment spending, in the form of diminished stock market purchases and business equipment expenditures, which has declined, significantly pulling down the entire economy. As a result, we should focus on increasing capital investments as a means of restoring our economy to health. Far preferable to any kind of stand-alone rebate would be for Congress to provide a front-loaded acceleration of January 1, of the across-the-board marginal tax rate reductions proposed by the President.

On a smaller but more immediate scale, small business access to capital can also be enhanced through the specific regulatory clarification that will fully implement legislation Congress passed several years ago such as Section 1045 of the IRS code as governing partnerships. For a more thorough explanation, please see my written testimony.

In addition, Congress and the President should act to encourage savings by increasing limits, as the Ranking Member just mentioned, of lifting the caps on IRAs, Roth IRAs and 401(K) plans. On regulations Congress should remain ever vigilant to guard against the growing morass that is encroaching on the high-tech and biotech industries such as rules on communications technology and export licenses.

Excessive regulation of any particular industry increases investment risks and thereby lowers the industry's access to adequate capital.

Remember that the American high-tech industry leads the world in virtually every area of competence and produces nearly half of its revenue from export sales to further benefit of the American economy. To my knowledge, there's no such thing as a high-growth regulated industry. Continued leadership for American companies could be threatened if regulations restrict the freedom of action that the industry has enjoyed to date.

Thus, policies that promote free trade, efficient stock markets, effective patent and copyright protection, tax treatment allows the expensive software immediately, makes permanent the R&D tax credit and removes obstacles to broadband deployment and workforce development through strong support of improving our education system, an area that we look forward to working very closely with the President and Congress would all be helpful.

The President's plan, along with these pro-growth tax initiatives and a cooperative monetary policy will help stimulate the economy. Then the Administration and Congress should forge ahead to reform Social Security into a payroll-tax-financed worker investment and personal retirement account program by allowing workers to invest a portion of their payroll taxes into personal accounts.

Again, I am honored and pleased to be before your subcommittee to discuss these vitally important issues. Although there's much work still to be gone to implement the President's tax relief package, I commend you for your leadership in beginning the discussion of the next steps to be taken in order to enhance our economy's growth and efficiency. Thank you.

[The prepared statement of E. Floyd Kvamme can be found on page 46 in the appendix.]

Chairman KING. Thank you Mr. Kvamme.

I also want to welcome the other Members who took all the trouble to make it down here. I appreciate the effort they went through to get here. And we have votes coming up.

What I would like to do is we will probably be leaving here in about 7 or 8 minutes and then come back.

Mr. Glassman, if you want to begin your testimony, we will perhaps finish your testimony before we leave to vote. Then we will come back.

STATEMENT OF JAMES K. GLASSMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. Thank you, Mr. Chairman.

Mr. Chairman, Representative Maloney, Members of the subcommittee, the message I bring you today is that the U.S. economy has slowed and that tax cuts and monetary easing are necessary, but not sufficient to restore the rate of growth we experienced in the late 1990s. What is critical is that changes are made in regulatory policy to encourage what I call the liberation of supply, the resurgence of output. I will give brief recommendations on how this could be accomplished.

First, however, I want to congratulate my friend, Floyd Kvamme, and say that it is an honor to be invited to testify here on this important matter especially in the company of such a distinguished group of economists including the Majority leader who just left.

You know, it was Ronald Reagan who said that economists are people who see something work in practice and wonder if the would work in theory. And what has worked in practice over the last two decades is the U.S. economy. We have far exceeded the record for the longest expansion in U.S. history. Since World War II we have had nine recessions, but only one since 1982, and that, by historic standards, was shallow and brief, but it still hurt. Recessions, even slowdowns, are extremely painful to real people.

Today, we may have already entered into the tenth post-war recession; at the very least, the economy has slowed significantly.

Let me just briefly review the causes of the slowdown, the reasons for the economic boom that we have seen, and some recommendations on unleashing the economy once again. Here are the major culprits as far as the slowdown is concerned:

Number one, Fed rate hikes. The Federal Reserve began to raise interest rates in June of 1999 with little sign of inflation. As far as I'm concerned, I believe it was a mistake.

Second, the tripling of oil prices. Eight of the nine post-war recessions, including the last four, have been preceded by an oil shock. It is the rising price of oil plus tighter Fed policy that tends to cause recessions, and this double whammy is present today, as well.

Third, the drag of high taxes and a gigantic surplus. Federal tax revenues as a percentage of gross domestic product last year were 20.6 percent—a level exceeded only twice in U.S. history, and that during World War II.

The surplus itself is a reflection of these high revenues flowing into Washington. Cash that could have been used for consumption or new private investments is instead being used to retire the bonds of investors who typically use the proceeds to buy more bonds. Retiring debt—especially with debt at such low levels as a percentage of GDP is no way to spur the economy. And I respectfully refer the subcommittee to my article, "The Joy of Debt" in the March 26 issue of *The Weekly Standard.*

Fourth, the end of the high-tech enterprise zone. The past year, especially, has seen increased Government intervention in the economy, especially in the high-tech sector as well as Federal and State mismanagement of the planned deregulation of telecommunications. A year ago, I argued that this change in political approach to high tech threatened a "regulatory recession." We may be in it.

It is no coincidence that high-tech stock prices began their 60 percent slide at almost the exact moment that the Justice Department asked a Federal court to break up Microsoft Corporation, the software company that is credited with igniting the computer revolution in the early 1980s.

But before getting to the question of what should be done to reverse the slowdown, let me just examine very quickly why the economy has boomed up to now. Business cycles work in fairly predictable ways. Prosperity causes demand to rise, it bumps up against supply, constraints of production and labor, prices rise, the Fed comes in and whacks down this inflation with higher interest rates, the economy slows, and frequently goes into recession and then we have the same thing all over again.

But for most of the 1980s and 1990s, that did not happen. We had strong growth—at times, twice the average with really very low inflation.

Why?

The reason is that the U.S. has been undergoing what I call a "liberation of supply." When demand rose, it did not bump up against supply constraints.

Why?

Let me just briefly cite four reasons:

One, the spread of free trade, both in goods and in people through immigration.

Second, lower tax rates and better regulatory policies that really began in the Carter and the Reagan years.

Third, better monetary policy.

And, fourth, Mr. Kvamme referred to this, the high-tech revolution. The advent of inexpensive, powerful network computers, has boosted productivity to about twice the historic average. Very simply, productivity means more output for the same input—that is, more supply.

But lately this liberation of supply has stalled, new bottlenecks and shortages have developed and steps need to be taken. Two of them, obvious ones, are already being taken.

First, the Federal Reserve has cut interest rates and will continue to do so. Second, Congress has begun action on President Bush's plan to cut taxes a total of $1.6 trillion over 10 years. And while the hearing is titled "Beyond The Tax Cut," I heard a lot of talk about taxes and I'm going to put in my two cents' worth. I want to emphasize the importance of significant tax relief, rather than a quickie short-term cut that will do nothing to stimulate the economy, in fact, it will probably be counterproductive.

I would also just like to associate myself with the comments of the Majority leader about expensing software and hardware. The single step that would give the economy the biggest boost would be to accelerate depreciation or allow expensing of capital investment. You get an immediate boost and a very big one. But we need more, specifically these few things:

Number one, the U.S. must formulate a clear energy policy that concentrates on encouraging supply. Currently, supply is being severely restricted by excessive environmental barriers to increase exploration for energy and by policies such as "new source review," that discourage the renovation of old refineries and utility plants and the building of new ones. This is especially hurting the high-tech economy in California.

Second, the antitrust policy of later years of the Clinton Administration should be changed to take into account the realities of high technology.

Third, the bottlenecks that are restricting the spread of broadband technology must be forced open. The main problem is the lack of enforcement of the main piece of regulatory legislation, the Telecommunications Act of 1996.

And finally, wireless, too, is being hurt by lack of supply. Regulators should get out of the business of allocating bandwidth to the politically powerful and instead let market forces determine who gets space on the spectrum.

The U.S. economy has shown that, when supply is liberated, growth rates of 4 or 5 percent—roughly double the post-World War II average are possible without inflation. With tax cuts, interest rate cuts, and a supply oriented energy policy and sensible regulations, we can revive a prosperity that will improve the lives of even more Americans than the boom of the 1980s and 1990s.

Thank you, Mr. Chairman.

[The prepared statement of James K. Glassman can be found on page 50 in the appendix.]

Chairman KING. Thank you, Mr. Glassman. We have to recess to vote. Probably we will resume at about 11:15.

Mr. Kvamme, I realize you're going to have to leave. There is no sense holding you around until the vote. I know Members have questions for you. If it is OK with you, we will ask them to submit those questions to you in writing and perhaps you can give us the answers.

Mr. KVAMME. Again, I apologize for that. But I would be very happy to, Mr. Chairman.

Chairman KING. Thank you, sir.

And also, Mr. Glassman, your article, "The Joy of Debt," without objection, I will have this inserted into the record.

Mr. GLASSMAN. Thank you, Mr. Chairman.

[The article referred to can be found on page 58 in the appendix.]

Chairman KING. We will resume about 11:15.

[Recess]

Chairman KING. The hearing will come to order.

I appreciate your patience and tolerance. Hopefully that was the last vote for a while and we will be able to continue with the hearing.

Our next witness was already introduced, and we look forward to his testimony, Dr. Martin Baily.

STATEMENT OF DR. MARTIN N. BAILY, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Dr. BAILY. Thank you. Chairman King, Ranking Member Maloney, and Members of the subcommittee, I appreciate this opportunity to be able to talk to you about the economy and some of the policies that might be affected in helping this economy move forward.

Let me just note, as speakers have mentioned, that we really have had an extraordinary period in our recent economic history. This has been perhaps the longest and strongest expansion of U.S. economic history. And a point that Jim Glassman made, let us not be too theoretical here, let's look at what worked in practice. The policies that were in place in the 1990s have contributed to and helped us achieve this extraordinary and unusual expansion.

One of the particularly striking things about this period is what happened to productivity growth. Productivity growth was very rapid after World War II for about 20 years, unfortunately, then it began to slow down in 1973. The time period is fairly short, but it does now seem, starting in 1995 and going through 2000, that the rate of productivity growth in the U.S. economy doubled or slightly more than doubled.

That is a transformation. It affects living standards, it affects family incomes, it keeps inflation down, it is a key to strong economic performance. We need to make sure that whatever we do we do not undermine that strong productivity performance.

Much of this performance was driven by new technologies, but those don't raise productivity unless you have the right environment.

Clearly, the economy started to slow in 2000. In part this was a response to actions by policymakers, and the Fed in particular, that the economy was running too fast and with a very tight labor market, that it needed to slow down. The resulting slowdown has been more abrupt than we wanted, and there are certainly areas of economic weakness that are evident here. But let us remember that even now the strong fundamentals remain, we have low unemployment and moderate inflation once the energy problem is under control. There is a good chance, not a certainty, but a very good chance that we will avoid a recession, but there will be pretty slow growth through much of a this year. After that, we're going to get a resumption of normal solid growth, even if we make no changes in tax policy at this point.

In terms of dealing with the current weakness, the evidence of history is pretty clear that monetary policy is the most effective way to avoid a recession or if we actually go into a recession to come back out of recession. And indeed the Fed has acted quickly to lower interest rates and to try get us back on track. Monetary policy takes a while to work and it may be uncomfortable while we go through this current period of slowdown, but let's give that, the right medicine, a chance to work first.

With respect to a tax stimulus package, past history suggests that manipulating taxes in order to save our economy is relatively ineffective and can be counterproductive. I'm certainly not the only one who thinks that. John Taylor, who is a distinguished economist, who is either now a member of this Bush Administration or will be soon, wrote a piece last year evaluating the role of fiscal stabilization policy and concluded that it generally is not very effective. And there are a number of reasons for that included in my testimony.

More importantly though, we need to keep in place the policies that have contributed to the outstanding economic performance of recent years. The policy of fiscal discipline as we shifted from deficits to surpluses has paid off quite handsomely in the performance that I mentioned. And in order to keep that fiscal discipline, we need to have realistic estimates on what discretionary spending is going to be. We need to be realistic, based on past actions, as to how much discretionary policy we're going to have and how much Americans want in terms of the programs that they are looking for.

The next aspect of fiscal discipline is that it creates surpluses that give us the opportunity to start dealing with the challenges of Social Security and Medicare. The long run fiscal position that the United States faces as we look into the century is not nearly as rosy as the current fiscal position. One way, for example, to deal with Social Security over the long run would be gradually to shift to a fully funded system so that as people paid in they built up an investment account and then they receive their retirement part back as they retire. We do not have that currently. We have a pay-as-you-go system.

In order to get from where we are now to where perhaps we would like to be, we're going to need a substantial amount of transition funding. And the surpluses, the ones over and above the Social Security surplus, give us that opportunity to do something about meaningful Social Security and potentially Medicare reform.

I would also like to draw attention to the international part of this. The U.S. is running a very large trade and current account deficit. We are borrowing nearly $500 billion a year. We have accumulated $2 trillion of net indebtedness.

The U.S. has have benefitted greatly from our ability to tap into global capital markets. That has helped us with our investment, it has helped our productivity, it has helped to strengthen this economy.

One of the concerns of this hearing is access to capital. We need to realize that we cannot keep borrowing at such a rate from overseas. There are natural forces as the debt builds up, a reduced willingness of foreigners to lend to us, that will make it difficult for continued very high borrowing.

In order to reduce the current account deficit, we need to increase national saving in our economy. Private saving is likely to rise moving forward. It's been so low in part because the stock market has been so strong. People haven't felt the need to save as long as their houses and stock portfolios have gone up so much. But as we have now had a flattening or decline in the stock market, we probably won't get the same astronomical gains going forward as we have had in the past. So I would expect private savings to rise.

But we need to reinforce that by making sure we also have budget surpluses which are a contribution to national saving in order to turn around that situation.

Rapid economic growth over the long run requires investing in the future. This helps productivity, which increases wages and family incomes. It also helps the budget surplus, which can get into a virtuous cycle as stronger economic growth improves the situation.

I am opposed to any large or long-term tax cut which would undermine the surplus. The surplus is needed to increase national saving and as a way to deal with the demographic challenge. The Social Security trust fund is scheduled to be depleted in 2038. There are not going to be Social Security surpluses going forward.

The tax stimulus package currently proposed would have only a modest effect on the current short-term weakness. Any tax cut that is designed as a stimulus should come into effect quickly and should be targeted to lower income families that need help in a softer economy. But whatever the pros and cons of a moderate tax cut or rebate to stimulate the economy, a large long-term tax cut that phases in gradually over the coming years is the wrong approach to deal with a temporary economic slowdown.

Something which came up in today's discussion has to do with falling investment. There has been a sharp fall in investment, but the main reason is that investment got ahead of itself in 2000. The economic growth was so strong, the telephone companies were out there investing, building more capacity than was really needed. There was perhaps more investment in high-tech than was justified by the fundamentals. That's the reason for slowing investment. Investment should resume as economic growth picks up.

Finally, the latest jump in consumer confidence is welcome, but I think a lot of American families are still pretty nervous. And one of the reasons they are nervous is they are worried about what is going to happen to them if they lose their jobs. They're afraid that they can't pay their bills, they might end up potentially in bankruptcy. They're afraid that their health insurance is going to evaporate.

So, this would be an appropriate time to review some of the Federal programs like unemployment insurance, and programs that help people without health insurance. If we strengthened some of those programs, it would help improve consumer confidence.

Thank you very much.

[The prepared statement of Dr. Martin N. Baily can be found on page 62 in the appendix.]

Chairman KING. Thank you, Dr. Baily.

Our next witness is a man who feels so strongly about this issue he braved the choppy skies and risked lightening and wind to come down here this morning, Larry Kudlow, an old friend. Mr. Kudlow.

STATEMENT OF LAWRENCE KUDLOW, CHIEF EXECUTIVE OFFICER, KUDLOW & COMPANY, LLP

Mr. KUDLOW. Thank you, Mr. Chairman and greetings to the panel. My own Congresswoman, Mrs. Maloney, greetings, Mr. Shays.

I just want to make a few points that I hope have not been made by my other fellow panelists. First of all, the Federal Reserve cannot do it alone. We have had a pretty significant reduction of the Fed's policy rates, the Fed funds rate, and the discount rate so far this year. They have knocked the funds rate down by one 150 basis points, as you know, and similarly the discount rate.

But the reality is, the stock market and the economy are still very much in the doldrums. And I want to put on the table the possible point for future discussion and that is, what really matters in the current economic setting with respect to the monetary policy, is not the level of the Federal funds rate, it is the volume of high-powered liquidity that the Central Bank injects into the economy. You know, this cycle was never plagued by the problem of rising inflation and rising interest rates.

Interest rate movements have been remarkably benign. I know they went up a little bit in 1998 and the first part of 1999, but, you know, as someone who cut his teeth in the profession in the 1970s, this is nothing. And I'm glad the Fed fund rate jumped from 6.5 to 5. And I believe personally when this cycle is over it will probably get to around 3.5 or so.

But, more important than the level of raise is the volume of high-powered cash that ejects to fund the economy. And there are two ways to measure that. One is the measure known as the monetary base, the other one is a subset of that measure which is adjusted bank reserves. And neither one has shown much stimulus in the economy so far. I just want to note that.

So we are in this strange position where the Fed is bringing down its policy rate, but there has been only the slightest improvement in general liquidity conditions. And this is a subject that is unfortunately quite technical and quite complex, but I can't begin to tell you how important it is.

I'm in agreement with Martin Baily, you can't do it alone, but I surely agree the Fed is going to be a major player. I don't think tax cuts will do it alone either. I think we need a shift in macropolicies toward lower tax rates and easier money, frankly.

So far we've gotten neither. And, therefore, it is not surprising that the stock market continues to decline. I characterize this—promises, promises, but what have you done for me lately? The answer is, virtually nothing.

Just to add another point to this Fed story, there was some increase in the monetary base in the month of January when the Fed first began to cut rates. You may recall the stock market did have a temporary rebound. But since then, the base has actually leveled off—a level base. And actually declined in its growth rate.

So, for the past 2 months the base growth has only been 1.6 percent; at an annual rate, that's a very meager rate. And another measure which takes the currency component out of the base is called adjusted bank reserves, which for the Fed—is the old term "non-borrowed reserves" essentially. Non-borrowed reserves have been essentially falling right now. They're falling. They're not rising.

So, my point is from the standpoint of the monetary side, a drop in interest rates is merely a reflection of the decline of economic activity. It does not include any particular monetary stimulus. And I speak here hopefully empirically and in a non-partisan way for those people who believe that the Fed should get the economy moving and I personally believe there's a good deal of truth in that point. The fact is, they are not getting the economy moving. They need to take a much more aggressive posture with respect to controlling the high-powered cash flows that they control. So that's point number one.

In the fiscal area, I found myself much more in agreement with Mr. Glassman than with Mr. Baily. And I want to make a couple of points on how I see the problem right now. Because we've had a very deep stock market plunge, which I believe today is more important than main street kitchens, than GEP, since there's over 100 million Americans who are invested in the market, the vast majority for long-term retirement purposes.

The stock market plunge has caused a significant increase in the cost of capital. There are many ways to show that, but let me just choose what I think is a fairly obvious one in the parlance of the—using the S&P 500 as broad as the most representative index of stocks. About a year ago, in March of 2000, at the S&P was pretty close to its peak, the price earnings multiple was roughly 33. The prices were roughly 33 times expected earnings.

Now, translating that into capital costs is very simple, just invert the measure and you get earnings divided by price, which gives you a bond yield. And at 33 times earnings, the bond equivalent is 3 percent. Take one over the PE multiple and divide. This is not a

Republican point, this is not a Democratic point, this is really a corporate finance point.

Now today, with the stock market down about, in rough terms, 25 percent the S&P, the price earnings multiple has fallen to something around 22 times earnings. And those are 22 times last year's earnings.

So the earnings yield has increased to 4.5 percent. I hope I haven't lost you already. But the point I want to make is, the earnings yield is one important measurement cost of equity capital. The increase from 3 percent a year ago to 4.5 percent currently is a roughly 50 percent rise. That's a very significant increase in the cost of equity money. And that is one of the most difficult consequences of the plunge in the stock market. It is now much more expensive for everyone to finance through equity fund. And I think we would all agree, we would rather American companies, both large and small, use more equity than debt.

So, with that in mind, I am concerned that fiscal policy, particularly tax policy, must help relieve the cost of capital increase which has occurred. And traditionally one can look at this as the interest rate cost of capital and the tax cost of capital. Although I want to underscore what Jim Glassman mentioned, essentially the regulatory cost of capital, which is an important point, but I'm going to leave that to his expertise.

Traditional corporate finance is on the interest cost of capital and the tax cost of capital. They're both very important. And so the kind of tax changes that I would recommend, the kinds of tax reforms I recommend would go to reducing the cost of capital. And that leads me to two very simple proposals:

One is the reduction in income tax rates, and, in particular, as unfashionable as my sentence is going the be, it is in this sense more important to reduce the top rates than the bottom rates. My view is, all rates should be reduced. But in strictly economic terms, with respect to the tax cost of capital, the upper income rates are really tax rates on capital, because that's the group that does the saving in our economy, and we save to invest.

Investment required saving. Once you get into the middle and lower brackets, there is virtually no saving and in the lowest brackets there is substantially negative saving.

So if one wants to promote economic growth, which is, I think, in many ways a different issue than various social-related issues; if one wants to reduce the tax cost of capital, then one would go to lowering the tax rate.

The other tax that, of course, comes to mind, and I'm not shocky with people know my—capital gains tax rate. Capital gains is the even more direct tax on capital. And so my recommendation, Mr. Chairman, to deal with this economic slump is to have immediate and retroactive reduction in marginal tax rates on income and capital gains. Those are not the only tax reforms that would be helpful. But, in an immediate sense, I believe they would—and I use this word advisably—"provide some shock therapy" to the stock market plunge; which, in some respects is feeding on itself right now.

You know, we are long past the point where normal discounted earnings follows a future market value. Make any sense? If earnings could fall by 10 percent in 2001, but if you discount those earnings by a 4 percent treasury bill rate, then the S&P 500 is at least 25 to 30 percent on the value right now, that's all very interesting, but the market keeps falling—forecasting, notwithstanding the market keeps falling. So I have concluded that we need some shock therapy to jar the quiescent animal spirit or investor spirits and create a better atmosphere. And I think reduction in tax rates on capital would be the best short-run policy.

I'm going to make two or three other quick points. In addition to the rising cost of capital, the market plunge has also generated significant increases of risk premiums on capital. Now that, in some respects, is very much related to capital costs.

One can see these risk premiums by the widening credit quality spread between lower-rated corporate bonds and higher-rated corporate bonds, and, of course, Treasuries, which are risk free.

As Mr. Kvamme has indicated in his testimony, there has been a general drying up of venture capital flows and there has been a general pull back in the initial public offerings marked "VIP" only. Those are all additional pieces of evidence that risk capital premiums have significantly increased. So I think we need to take some tax measures and some monetary measures to jolt the market attitude and to, if you will, create some shock therapy.

As far as the economic outlook goes, I really believe for those people who want an immediate tax cut on consumption, I mean, I'm obviously sympathetic to the idea of an immediate tax cut, but I must tell you, consumption is not the problem right now. Consumption is not as healthy. Personal spending, personal consumption expenditures, which is the largest category in the national income accounts, are not as strongly growing as they were a year ago. But, really, they are still positive. Up about close to 4 percent in the fourth quarter, and I guess they'll be up 3 percent or so in the first quarter.

Retail sales are rising, albeit more slowly. Automobile sales are still at a high level. The analysts have pointed out, I think Mr. Greenspan has pointed this out, incomes are still growing however the slowdown and so forth.

Where the real weakness is occurring in the actual data is on the investment side of the income potential accounts. In particular, industrial production has fallen 5 straight months. A sixth month of that could qualify as a recession indicator. And factory orders and shipments continue to decline. We got more bad news on that yesterday. There is an overhang of inventories across the board. And gross domestic investment declined in the fourth quarter and is set, in my judgment, to fall again in the first quarter.

So we have an investment side recession. We have a capital cost problem. We have an investment risk premium problem. And I would argue that to generate long-run health of the economy we should be looking at the supply or investment or capital sides of the calculation, not the consumption side.

And, yes, I am a Wall Streeter and, yes, there is, therefore, some preoccupation with the stock market. But I must tell you, what has happened in the stock market is not something to be just sloughed off, oh, it will recover, it will recover. I remain an optimist in the long run, but I can tell you, the stock market plunge is taking its toll on the economy, on sinking investment spirits, and on the risk-taker. And to expand the productivity revolution that Martin Baily discussed, a point with which I completely agree with him—completely—we need more capital. It is in many ways our most valuable resource. It is capital that makes labor productive.

Thank you.

[The prepared statement of Lawrence Kudlow can be found on page 68 in the appendix.]

Chairman KING. Thank you, Mr. Kudlow.

Over the next several weeks and months we are going the have very intensive debate in Congress about the President's tax policy and whether or not it should be expanded, whether or not it should be restricted. And my concern has been that there appears to be a distortion of certain basic facts. For instance there almost seems to be a—taken as gospel—that the Reagan tax cuts of the 1980s did not work; it hurt the economy, interest rates went up. My understanding of the Reagan tax cuts is that interest rates—dramatically cut, 18 million jobs were created, inflation were dramatically cut, 4 million Americans came out of poverty during that time. It was the longest peacetime expansion we had.

We have, over the last 19 years, had one brief recession. And yet, both the media and among certainly many members in the opposition party there's talk that these tax cuts did not work. You can go back to the Kennedy tax cuts. There was no surplus either. Those tax cuts worked.

So I would like to ask, what we can learn from the Reagan tax cuts and how they are applicable to today, and how real are the fears that if the economy does take a bit of a downturn, or if there is a brief deficit that somehow this is going to ruin our economy for years to come. So I would just ask the three of you, I guess in order, Mr. Glassman, Mr. Baily, Mr. Kudlow, the order in which you testified.

Mr. GLASSMAN. Well, Mr. Chairman, I agree with what you said. The Reagan tax cut certainly worked. Imagine today if we confronted top rates of 70 percent on so-called "unearned income." This was the disdain with which policymakers viewed investing. They called it "unearned income." The top rate on earned income was 50 percent. The Reagan cuts essentially "liberated"—a term I used in my testimony—investment and to some extent worked. And, indeed, while deficits rose, although they did not rise because of these tax cuts, interest rates fell. The economy boomed. The contrast between the 1980s and the 1970s could not be more stark.

So, yes, marginal tax rate cuts work. Unfortunately, they did go back up over the last 10 or 20 years. Well, we still had rates considerably low. So I think that the Bush tax cuts, which concentrate on marginal rate reductions are a good idea and they are certainly a step in the right direction.

Chairman KING. Mr. Baily.

Dr. BAILY. Just briefly. The late 1970s and the early 1980s was a very difficult period. There was very high inflation, double-digit inflation. There was then a very deep recession in 1982. Following that, there was certainly strong economic growth as the economy came out of that very deep recession. Much of that growth was recovery from the recession and then there was some reasonably solid growth after that, in part, because a lot of people were coming into the labor force. My concern about the Reagan tax cuts—by the way, I think 70 percent margin tax rates are too high—was they were too large, they were based on an unrealistic view of how much expenditure was going to be cut and so there were very large deficits. Those did increase interest rates relative to what would have occurred otherwise.

They disrupted financial markets, the international exchange markets and we ended up with a big trade deficit, so we actually were borrowing overseas to cover those deficits, which is not what we are doing now. We are borrowing overseas today to cover private investment. Then we were borrowing to cover Federal deficits.

And the other thing to keep in mind is that productivity is really a key to whether you can keep expansions going or whether limits are going to arise. Productivity slowed after 1973 and it really did not accelerate in the 1980s. It stayed at a very mediocre pace. The idea that large tax cuts would liberate higher productivity. That did not happen.

Chairman KING. Mr. Kudlow.

Mr. KUDLOW. I'll just sign on to what Mr. Glassman mentioned in aggregate terms. I will make a wee bit of a follow-up to my friend, Martin Baily, that in my view, and I guess I was there in OMB counting numbers, some days were better than others in those days. The single biggest source of the cyclical budget deficit was the rapid deceleration of inflation, which we did not build into our numbers, because when Jerry Jordan and Craig Roberts and—Jerry and I said, if the Fed could get inflation down in a year or two, no one in Washington agreed with us.

People hauled out their Phillips curves and told us this will take 8 or 10 years. You probably could never get inflation down. It was rising upward to 12 to 15 percent on the CBI. And, Mr. Voelcker, who was a very heroic Fed chairman, if unpopular, he was heroic, took the inflation rate down from the 12 to 15 percent peak to 2 to 3 percent inside of about 18 to 24 months.

And anyone who knows how the budget works knows that revenues are estimated from the rate of rise in nominal GDP, which is representative of national income. And the rate of rise in nominal GDP was collapsed in the early 1980s. So the inflation sponsored revenue increases that we had lived on for the prior 10 or 12 years evaporated and they did so in an 18- to 24-month period. That was the single biggest source of the deficit.

I actually, with all respect in looking at the numbers, would note that although the Congress may have spent too much, "aggregate spending," totals from the Congress in the 1980s were not significantly different from the aggregate spending totals provided by the Reagan Administration.

The priorities were different. But the aggregates were remarkably similar. And so I have never taken the view that deficits were caused by too much spending. Indeed, the Federal share of GDP began to fall in the 1980s and it intensified in the 1990s, a good thing. But my point is, it was rapid, rapid disinflation. And it wasn't—we had to do it, whatever, that's what happened.

The second point is, we had trade deficits for 20 years. The best way to cure a trade deficit is a recession. The only time we went close to trade surplus was 1990–91, which was our last recession. And I don't agree with Martin, foreign capital has been flowing into the United States for 20 years, because we've had the highest investment rate of return. And that's one of the reasons our productivity rates are so high.

And I'll just add, Mr. Chairman, I have never seen empirical evidence, I have never seen empirical evidence whether it's regression analysis or any other statistical means that proves a relationship between deficits and interest rates or debt and interest rates for the U.S. economy. For other economies, particularly in Latin America and Asia, yes. For the U.S. economy I've never seen it. And I gave a paper to this effect at the American Enterprises 2 or 3 weeks ago.

Chairman KING. Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman and I would like to welcome all of our panelists, particularly Mr. Larry Kudlow who is from the great State of New York and actually a neighbor on 93rd Street.

Mr. KUDLOW. In your district.

Mrs. MALONEY. Absolutely. And, Mr. Glassman, it's so wonderful to meet you in person and not your website or one of your many TV appearances.

And I would particularly like to welcome Dr. Martin Baily from the Institute for International Economics. Dr. Baily served as Chairman of President Clinton's Council of Economic Advisors. I truly believe that one of the reasons that we had the economic successes during the Clinton Administration, 8 years of sustained economic growth, was the high level of people who served, particularly in the financial services area with Rubin, Summers and Dr. Baily at CEA. So I welcome you and I thank you for coming. I do appreciate it.

I would first of all like to ask Dr. Baily to respond to Mr. Kudlow's remarks about the so-called "tax cost of capital" that we need shock therapy to reduce rates and capital gains in the economy. And also his comment that deficits are not caused by spending, but by other factors and that the way to cure a trade deficit is through a recession. I would just like to hear your counterpoints on that.

Dr. BAILY. Cost of capital, the second one was?

Mrs. MALONEY. His statement that deficits are not caused by too much spending.

Mr. KUDLOW. Deficits in the 1980s.

Dr. BAILY. Well, the price-earnings ratio in the stock market is one element in the cost of capital. What I would do is put this somewhat more into a historical perspective. We had had a tremendous run up in the stock market. If you look back historically the price-earnings ratio might have been around 12 and then it got up to 33 and now it is back down a little bit. You may recall that Chairman Greenspan talked about "irrational exuberance" in the stock market. I think the Dow was around 6000 at that time. So we just had an enormous increase in the stock market which went beyond any good estimates of what earnings growth was likely to be to sustain it. So there has been a correction. I'm not going to forecast where the market is going to go in the future, but I think we have seen a correction, a necessary correction to get a little bit more realism into the market. And the market is still very strong in terms of its overall level. I would not regard it as providing a significant barrier to investment.

The problem with investment right now is the overinvestment that took place in the boom. Companies now need to get back on track as we restore growth; which I think we can do.

As to the deficits in the 1980s, it's a matter of arithmetic. A deficit is the difference between what we take in and what we spend. So it can be affected by both sides of that equation.

What happened in the 1980s was that we promised that there were going to be bigger cuts in spending or that spending was going to be controlled, in a way that did not happen. For good reason. A lot of programs people want to have in place.

Another thing I mentioned about the 1980s is that although there were significant cuts in income tax rates, there were increases in payroll tax rates, so that a lot of people at that time did not experience a tax cut. And looking forward, as I mentioned in my testimony, the share of discretionary spending in GDP has been going down. It went down significantly from FY 1992 to FY 2000. Given the need for a strong defense, given the kind of investment programs in technology that are helpful to growth into the private sector, you have to take a realistic look at how much further squeeze there is likely to be on spending. Then think of the tax cut in that context and what we can sustain and still keep the surpluses going.

I don't know what to say about this recession reducing the trade deficit. Technically it does. If everyone stopped spending then they would stop buying from overseas. But I don't think Larry Kudlow believes we should induce recessions to cure the trade deficit. What we need to do is to find a way to make sure that we sustain the level of national savings. We can do this by increasing private saving and maintaining public saving. This would bring more of a match between what we produce and what we spend. That's the way to reduce the trade and foreign account deficit.

Chairman KING. The gentleman's time has expired.

The Chairman of the full committee, Mr. Oxley.

Mr. OXLEY. Thank you. Mr. Chairman, let me welcome our distinguished witnesses whom I've followed for a number of years and appreciate their contribution to the debate. Let me begin.

Mr. Kudlow, you mentioned that consumer spending tends to or continues to be relatively robust, if I don't misquote you or misstate it, and yet most economists tell us that two-thirds of our economic growth is consumer spending. If that is the case and we still have this robust consumer spending, then why are you telling us that the economy continues to falter?

Mr. KUDLOW. Well, because consumer spending is almost always roughly two-third of GDP, whether the economy is rising or falling. That's just the way the arithmetic works. At the margin, however, it is highly unusual for consumer spending to lead a downturn. It is almost always—the downturns are almost always found in the investment side of the accounts, either inventories or production or gross domestic investment. That's what causes swings in business cycles.

Now, we have had periods, particularly in the late 1970s, early 1980s, when the inflation rate was so high that almost definitionally, logically, real consumer spending fell and it had as much to do with the gigantic boost of inflation as it did the actual drop in the volume of sales. And, actually, right now there's a little risk here depending on how one measures it.

In recent months, the last 3 months, the increase in retail sales, which is a smaller component of consumer expenditures, that increase is just barely keeping up with the inflation rates—CPI. It's mostly energy and natural gas-related. But, yeah, that's the reason. PCE just, you know, is always whether the economy is up or down. It very seldom turns negative. When it does we are in a heap of trouble.

Mr. OXLEY. Let me ask Mr. Glassman if he agrees with that general viewpoint?

Mr. GLASSMAN. I do Mr. Chairman.

Mr. OXLEY. And, Dr. Baily?

Dr. BAILY. You made a valid point, which is that consumption is a big part of the economy and since it's continuing to grow, that's an optimistic sign that we should be able to get through this period without recession, even though there is a risk of recession.

Mr. OXLEY. I've heard many people opine on the question of whether, in fact, the stock market is really the economy and I've heard a number of people say, that indeed the stock market is not the economy. Let me ask you Mr. Kudlow, that is the old adage that the market is predicted viable the last three recessions, don't you concur that the stock market is totally separated from the economy?

Mr. KUDLOW. No.

Mr. OXLEY. Well, let me ask Mr. Glassman, do you agree with that?

Mr. GLASSMAN. That the stock market is separated from the economy?

Mr. OXLEY. Yeah.

Mr. GLASSMAN. No, not at all. In fact, the stock market frequently tells us what the economy is going to do next But there are major feedbacks, and I think this is what Larry was saying, that when people feel that their wealth has declined as a result of a sharp decline in the stock market, even if they don't plan to use their 401K plan for another 20 years, they cut back and it's not good for the economy. There are definitely feedbacks.

Mr. OXLEY. Well so far as though we haven't seen that.

Mr. KUDLOW. Oh, yes, we have, we've seen it. We've seen a slowdown, it's just not a feedback on consumption. It's a very nominal fee. I never bought into the consumption wealth, stock market wealth view that Mr. Greenspan has.

Mr. OXLEY. You never bought into the wealth effect concept?

Mr. KUDLOW. Which Mr. Greenspan himself has recently abandoned. My point is the accepted point, different point. In corporate finance terms movements in the stock market affect the cost of capital and the returns to capital, and that runs right through entire investment process.

In other words, the market is integrated to the economy, because people in business, men and women in business, have to make basic capital decisions, to invest or not to invest and I—buying stock in their own companies. And they do that, in large measure, based on capital cost which can be looked at in terms of interest rates as well as taxes. There's a tax cost of capital and an interest cost of capital.

What we've had in the last 12 months is a plunge in the market, an increase in capital costs and we've had a significant slowdown of investment spending in the economy. So there's your link, it runs on the investment sides, not just the consumption or down side.

Mr. OXLEY. Thank you. My time has expired. Thank you, Mr. Chairman.

Chairman KING. Thank you Mr. Chairman.

The gentlemen from California, Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman.

Dr. Baily, I want to explore something. Looking at your written testimony under the summary.

Dr. BAILY. Yes.

Mr. OSE. Down at the bottom you talk about a tax stimulus package for a very large, long-term tax cut. The first point is that the tax package is likely to have a modest effect on current short-term weakness, and then your second point is that a very large long-term tax cut that phases in gradually over the coming years is the wrong approach to deal with a temporary economic slowdown.

My question is, if we reversed the hypothesis—that is that a tax increase package is likely to have only a modest effect on the current short-term accounting, how long of a lag do you envision in that impact? Is it 6 months, is it alleviated in 18 months?

Dr. BAILY. We're talking about a short-term, immediate package?

Mr. OSE. That's my first question, yes. If a tax stimulus package is only going to have a modest effect, how long before we get to that effect?

Dr. BAILY. If it went into affect immediately, I would expect its' impact to be fairly quick. Of course, people have to feel it in their after-tax incomes, so you have to get it through Congress and signed. If it were a tax rebate then people would get it right away. If it's a reduction in rates, then it would take a while before people would actually feel it in their household after-tax income. But the impact would certainly be 6 months or so.

Mr. OSE. Would that be the same in your comment about the very long, large, long-term tax cut is the wrong approach to deal with temporary economic explosion. Is it your point that a very large, long-term tax cut should be oriented toward a very long-term economic prosperity?

Dr. BAILY. That's correct. And that long-term tax policy should be geared toward maintaining economic prosperity. We obviously have disagreement here. Many of the witnesses or Members of the subcommittee believe that the tax cuts are a way to get prosperity.

The argument that I am making in this testimony is that running surpluses and maintaining fiscal discipline is the best way to continue the prosperity. Either way, leaving aside that difference, the setting of long-term tax rates should be based on the goal of long-term prosperity.

Mr. OSE. So your point is that, it takes almost a triangulated approach between fiscal policy, monetary policy and tax policy to make the economy right?

Dr. BAILY. Yes.

Mr. OSE. Well, we passed a tax cut here in the House and the Senate last August and the President vetoed it. Can you give me some indication as to why he said that we don't need it and now 6 months later we're clearly in an economic downturn?

Dr. BAILY. Well, it was a large tax package, it was long term and the President believed—and his economic advisors believed—that this would undermine the fiscal discipline which we felt had brought us the very strong prosperity or contributed to it. The private sector obviously is the prime mover there. That was the reason that the tax package was rejected by the President.

He also had some concerns about the distributional effects of that tax cut. He felt that if you were going to have a tax cut it should be that more of the tax relief should go to lower-income families.

Mr. OSE. If I might follow up on that. I know by that time Mr. Rubin had left the cabinet. I'm curious. Did the President or anybody ever visit with Mr. Rubin about his perspective on that proposal?

Dr. BAILY. Well, I was not party to private meetings, but I know he respects Mr. Rubin's opinion and I imagine he continued to consult with Mr. Rubin. But I have no personal knowledge of that.

Mr. OSE. Thank you, Mr. Chairman.

Chairman KING. The gentlemen from Connecticut, Mr. Shays.

Mr. SHAYS. Thank you. I appreciate you holding this hearing. This is fascinating stuff. It's fun to be on the Budget Committee and look at these issues a little differently. But let me first tell you from my budget experience, I thought that one of the reasons we eliminated rapid—was that we wanted Government to get off the spending at least during the 1970s and the 1960s, so to say that the 1980s wasn't any different to me, it was, that's the shame of it, it was supposed to be different. And I just make that observation.

But my first question is this, there must be different types of investment spending, because I have trouble Larry, Mr. Kudlow, with the concept that inventory has been down, you know, that's the area of focus, excuse me, inventory has been up, spending of inventory has been down. The reason why spending of inventory went down was that there was no consumer spending eating up that inventory.

Mr. KUDLOW. Actually, most of the weakness on that side is from business, decline in business spending of the inventory.

Mr. SHAYS. No, this is not——

Mr. KUDLOW. And when I refer to investment, Chris, or Mr. Shays, I'm talking about investment in structures and equipment. Yes, we're having an inventory correction, but I kind of pushed that aside. We get inventory pressures from time to time, so I'm not——

Mr. SHAYS. Mr. Glassman, your article is fascinating. One of the interesting things about that, I got excited when we coupled Social Security—the debt reduction, because it was based on just spending. And also, we only had three options, basically, we condition spend it, or we can provide a tax cut, or we can pay down debt. Those are the three basic areas that I see my ability in Government. And so I guess the question I am asking is, has it been a healthy way for us to cut down spending, by suggesting some of this surplus go to get out of debt, and so isn't it a question of how much debt we could have?

Mr. GLASSMAN. Well, I think the objective is defensively to stop spending. The best way to do is by stopping the flow of tax revenues into Washington through a tax cut. I think that's a much better way to do it than retiring the debt.

Mr. SHAYS. But we all are trying to be somewhat practical here, I mean, its my choice then that we go this way, do you agree that having a tax cut, may be even larger. Once we got to that point the choices in the last 3 days and in debate was spending more on a tax cut and there is a lot of interest in spending. I mean, we're right about the caps——

Mr. GLASSMAN. I agree. And spending more, first of all, I want to say I think Martin and I were—and certainly Larry, more than I—were among the few who saw these surpluses developing 4 or 5 years ago. And my great fear was exactly what's happened over the last couple of years, which is, it has spurred Congress to bigger spending increases in the last few years than we've had since the 1970s. How to stop that?

I think really the only way to do that is through a tax cut.

Think about this: the Congressional Budget Office, in the January 31 report, says that by 2006 we are going to have paid off all the debt that we can pay off. It will all be gone, and then we are going to start what the CBO calls "uncommitted funds." They had to actually invent a term for this, which is money flowing into Washington that can't go to pay off the debt, because it's already paid off.

Mr. SHAYS. It's going to be spent at this moment, my concern is——

Mr. GLASSMAN. Exactly. It is going to be spent and so we need to reduce that flow and, by the way, it would also help the economy to reduce that flow through a tax cut.

Mr. KUDLOW. I mean, if debt retirement were going to stop spending——

Mr. SHAYS. You need to get closer to the mike. But make it short, if you could.

Mr. KUDLOW. If debt retirement was the path to lower spending, then it would have been the path to lower spending. But it hasn't been. We've been retiring debt—spending more.

Mr. SHAYS. Let me just say, if we were not retiring debt we would be spending more. I mean that is the challenge.

Mr. KUDLOW. Maybe, I mean maybe. All I'm saying is——

Mr. SHAYS. Well in my 13 years here, you know, I just see it's too darned easy. And my Republican colleagues are willing to spend as much my Democrat colleagues.

Mr. KUDLOW. Well, all I'm saying is that we have been retiring debt in the last couple of fiscal years and as an experiment we have not, this is not spending increases. That's all I'm saying.

We're not spending all of it. We are retiring debt at a rate of $1 billion per businesses day. It's quite amazing. But if we were not getting that money flowing into Washington, then there would not be any conditional spending and there would not be as much debt retirement.

Mr. SHAYS. We're going to have a few more rounds, yes?

Thank you.

Chairman KING. Mr. Grucci.

Mr. GRUCCI. Thank you, Mr. Chairman.

First let me acknowledge some of the students that are here from the eastern end of the first congressional district. Welcome and I hope you're find this enlightening, because I certainly am.

Mr. Kudlow, you have testified that capital gains reduction is helpful to the economy. And if you do believe that and I happen to agree with that same philosophy, if you do agree with that and you have stated that you do believe that it does work, to what level should it be lowered or should it be eliminated completely? And if it is eliminated or lowered, to what impact do you see that having on the economy, the projections, the surpluses that are materializing or for us to keep on course through our current tax plan, budget that was outlined so far?

Mr. KUDLOW. You know, there are two Presidents who have resided over significant reductions in capital gains. One is Ronald Reagan and the other is Bill Clinton, and they both enjoyed tremendous economic success through the process. And both times the revenues generated from capital gains went up. I have a chart in my testimony on the Clinton capital gain effect. So I think we have a lot of evidence, it's a good thing.

Now, you asked what the right rate is, I'm not sure I have all that listed. We're talking about a general tax reform and simplification plan, which is something I devoutly desire. It might be possible to eliminate cap gains or perhaps drop it to something around 5 or 10 percent. It is currently, as you know, 20.

I don't know, I think right now dropping it from 20 to 15 would be an enormous help to the deteriorating investor spirits. It would aid the return on capital, it would help offset the higher cost of capital. All of which I think are the biggest issues right now from the economics spectrum.

Mr. GRUCCI. Thank you. If I have time left, Mr. Chairman, I'd appreciate the other panelists' position on that same question.

Mr. GLASSMAN. Well, let me just add another perspective to this, and that is that one of the problems with a high capital gains tax rate, that's what we have right now, is that it misallocates capital. People tend to hold onto their investments, even when they are not good investments, because they do not want to take—they don't want to be hit by the capital gains taxes. And I think that's one of the problems we ran into in what a lot of people consider a tech bubble. People have built up gigantic gains in stocks that they probably had come to realize were not necessarily very solid companies. And without really being able to get out of those stocks without being penalized by a high capital gains rate, moving that money into probably better uses for that capital. So that's one of the big problems that capital gains, high capital rates cost us.

Mr. GRUCCI. Thank you.

Dr. Baily.

Dr. BAILY. A moderate tax on capital gains is appropriate. It's fairly easy, well, not fairly easy, it's certainly possible for many people to shift whether they receive income as general income that's subject to the ordinary income tax, or whether they receive it as capital gains. If there is no capital gains tax at all, there's a danger that this becomes a way of avoiding taxes altogether. I would suggest that we have a reasonable capital gains tax rate.

The rate that's in place now—during this period there has been a tremendous investment boom. There has been almost too much money floating out to people with fairly vague business plans. The capital gains tax that we had in place in this period has certainly not been associated with a particular shortage of capital.

Mr. KUDLOW. But the only—if I could just——

Mr. GRUCCI. Sure.

Mr. KUDLOW. As a tax reform as someone that has long advocated flat tax type reform, my criteria is that income be taxed only once. And when you get into capital gains and other forms of saving and investment taxation, there is multiple taxation and that renders the system a lot.

Mr. GRUCCI. I must say, I share your opinion on taxes—for the American people.

Thank you, Mr. Chairman, I yield back the remainder of my time.

Chairman KING. Thank you, Mr. Grucci.

Ms. Hart—I'm sorry, Dr. Paul.

Dr. PAUL. Thank you, Mr. Chairman. I want to direct my questions and comments to Mr. Glassman and Mr. Kudlow. But basically I think I'm in agreement with much of what you say, because I'm a strong proponent that we ought to get taxes down, the sooner the better, the more the better. I also think that we ought to cut spending and cut regulations all to help the economy. And the more the better. I wanted to make just a comment about the surplus, where I have some slight disagreement. I don't really want to dwell on that as I do think that we should be concerned about the obligation of the Federal Government and that has not been shrinking.

The only thing that shrinks is the marketable debt. So we have a tremendous obligation, whether it's considered debt or whether it's considered the national debt, the official national debt actually hasn't shrunk. And those numbers may well change in a recession, because at the peak of the market our assumptions are wrong, but we have more revenues than we think. At the bottom it's the opposite, we have a lot less than we assume. So I think that is a future problem.

But I want to talk more about and get you to comment on monetary policy and interest rates. Because you seem to accept the definition that most everybody here accepts as the definition of inflation. That is, if you look at CBI and the CBI doesn't go up, there's no inflation. And I disagree with that. Because from the Austrian viewpoint, you look at the money supply. And the money supply is increasing significantly.

If you look at MZM right now, which is the best measurement of the money that's available for spending, it is currently going up at a 28 percent rate. So there's a lot of money there, and that to me is inflation. And even to argue that we have no inflation by the CPI and the PPI, we can look to—which you admit we have rising prices, services are going up rather quickly, medical fees are going up, education costs are going up, the cost of housing is going up and something nobody wants to put into the cost of living are taxes. So these are all going up.

So I think there's tremendous inflation and an Austrian economist would also include the inflated prices in the stock market. And when you have excess credit floating out there, people do dumb things. They develop overcapacity and malinvestment, and they "over-speculate."

So instead of arguing that we lack capital, and lack money, I would say the opposite is true. We've had way too much.

Greenspan expressed a concern in 1996 about the stock market, and since that time he increased the money supply by 50 percent and M3 went up over $2 trillion. And, again, the attack on the Fed for not addressing this quickly enough and forcefully enough, we failed to remember that raising interest rates aren't always that harmful immediately.

In 1994 to 1995 he raised interest rates 7 times. We didn't have a recession. Nobody was hollering and screaming. But right now he raised them and the market is ready to correct from all the inflation. So I would say that it's a serious mistake not to recognize that it's the mischief of the Fed that's causing it—which you might agree with—but you're saying, "Well, what we need is more money." Under capitalism, capital comes from savings. But we have no savings. We say, "Oh, no, the stock market is up and that's life savings." Well, does that mean that we lost $4 trillion worth of savings in the last year? It's because we have no savings.

And I don't see how you can solve the problem of inflation with more inflation. It seems like the only debate that goes on here is how wide the spigot should be. Should it be coming faster or slower? And when you come up with the inevitable slump that always comes from the inflated monetary system, the money supply, then the only answer is, well, you didn't inflate fast enough, or you turned it off too soon.

I would ask you to comment on those remarks.

Mr. KUDLOW. Well, you covered a lot of ground, Congressman. Let's see, I'll try to—I used to be a fairly devout reader of—and, as I recall, he measured the value of money based on commodity indexes and gold, both of which have been generally falling in the last 20 years. I think that's about right. We've been in a disinflationary environment bordering on deflation. So that's my basic comment.

Technically I think you're confusing money supply with money demand. People are front loading their money into institutional and retail money market funds. That's a classic signal of the lack of confidence in the market and the economy. So as a result, MZM is rising rapidly. But that's a function of the increased demand for cash and typically in an atmosphere of declining interest rates, the opportunity—cash has come down quite a bit. It is not a healthy economic sign. The only money the Fed controls is the money they create, which is bank reserves and that continues to decline, and that's a deflationary signal. And I would hope that this subcommittee would explore these issues, because I believe Federal Reserve policy needs to come under much greater scrutiny.

Dr. PAUL. My time has expired.

Chairman KING. Thank you, Dr. Paul, for your questions and for being an honorary panelist.

Ms. Hart.

Ms. HART. Thank you, Mr. Chairman. I actually don't have any questions for the panel, but I do want to thank them for coming here and discussing this issue as we continue to debate these issues as the actual full Congress.

Chairman KING. I thank the gentlelady.

Do you have time for one more round? There are some more questions that I would like to ask.

I would just to ask on question. Addressing the whole, what I call "class warfare" about how too much money—that the tax cut plan cuts too much for the top level. My understanding is that when Reagan came in, in 1970, the top rate was 70 percent, now it's 39. It went down further at one time. Still it's gone from 70 to 39, and yet the people at that top rate in 1980 were paying 18 percent of total revenues, now they're paying 30 percent of total revenues, which seems to indicate that as we reduce the rate at the higher level they actually end up paying more.

Now, maybe I have that backward, and I really would ask that you clarify that, or is that accurate?

Mr. GLASSMAN. Mr. Chairman, that is exactly accurate. The thing I would just add about the top bracket, it's very important to understand is that the majority of businesses in American are sole proprietorships or partnerships. So they are taxed, most of the ones that are doing half decently, at that top rate. So we are not just talking about rich individuals, we are talking about most half-decent sized American businesses.

Chairman KING. Now, these are Sub-chapter S companies?

Mr. GLASSMAN. Right. So we are talking about Sub-chapter S corporations, partnerships and sole proprietorship, and LLPs. So that is the majority of American business. That's the rate that they're being taxed at, 39.6.

If you take the rate down a little bit, you'll have a big impact on those folks who tend to be very entrepreneurial, it will increase the flow of capital to those businesses and it will increase investment and work. So its very important.

But your original point is very well taken. It is also, of course, one of the political difficulties of cutting marginal rates. The top 1 percent of earners pays 34 percent of the Federal income taxes.

So any time you're going to have anything that's close to an across-the-board tax cut, obviously people who pay most of the taxes are going to get the biggest benefit in terms of absolute dollars. Not in terms of percentage. In fact, the Bush tax cut gives the biggest percentage cuts to people in the lower brackets.

Mr. KUDLOW. I just think that—I'm sorry.

Chairman KING. Go on, Mr. Kudlow.

Mr. KUDLOW. I just want to make an—you know, I think—the bottom rate is consumption and the top rate is capital. I mean, that's really how our system works.

Mr. SHAYS. Say that again?

Mr. KUDLOW. he bottom rate is consumption and the top rate is capital. That's really how it works. And, you know, I think you've got some political forces who want to ease the tax rate on the consumption and others want to ease the tax rate on capital or investment. You know, you can do both. That's what the beauty of across-the-board rate reduction is. It just occurs to me. I mean, Martin Baily was talking about, you know, if you pass a tax cut it will take effect on the economy pretty quickly. And it just strikes me that two things happened here and they merged together as some of the arguments.

Number one, if you lower tax rates across the board, the IRS will make the adjustment to the polling rates, and in this case it's a downward adjustment. Well, that includes cash flow. So in that sense it's consumption oriented. But it also changes the incentive system, because the extra dollar will be taxed at a lower rate, which provides for greater reward for work effort and investment capital decisions. So both work together. You also get the benefit of dropping investment costs. But my point is, supply siders argue the rate reduction, because it affects behavior through a better reward system. Well, I think we need that after the Fed has eviscerated the stock market. You know, it's time for some rewards. But, also, if people are concerned—fine, because their cash flows as Jim Glassman indicated, their cash flows will benefit. It's win/win. But if we choose one or the other, I think you're leaving the realm of economic policy and you're going to the realm of social policy. That's what I think. And, you know, I think right now we need economic recovery policy, not social policy.

Chairman KING. Dr. Baily.

Dr. BAILY. If I could just make a quick comment. We want people to be successful and those who are successful make money. That's great for America. And, as we said, many of them are in small businesses, some of them are large businesses. The reason the proportion of tax revenue paid by people in the top brackets has risen is that the economy has done so well. There are more people moving up into higher brackets. Also, there has been some widening of the income distribution. Certainly as you look at taxable income, the distribution has widened. Many of the benefits of this very strong expansion have gone to people in the upper income brackets and they have then paid the tax rates that apply to that group.

We were just talking about the availability of capital. Most of the capital that is generated in our economy comes from retained earnings of corporations. Corporations do pay taxes, although the proportion of revenue coming from corporate taxes has gone down. The availability of capital for investment is largely generated by internal funds from companies or may be subject to the capital gains tax rate which is lower.

Chairman KING. Thank you.

Mrs. Maloney.

Mrs. MALONEY. Dr. Baily and the rest of the panel, many of my colleagues are comparing the Bush tax cut plan to the Kennedy-Johnson tax cut of 1964. The Kennedy-Johnson plan cut the highest tax rates from 91 percent to 70 percent, thereby tripling the benefit of each dollar an individual earned. The highest bracket decrease proposed by the Majority would go from 39.6 percent to 33 percent. While this overwhelmingly skews the benefits of the overall package to the wealthiest taxpayers, at the same time there's only an 11 percent less tax burden for those taxpayers. Is this plan truly comparable to the Kennedy-Johnson tax cut, would you say, or—and would you add, would a reduction in the estate tax be an effective economic stimulus? Dr. Baily and then Mr. Glassman and Mr. Kudlow, your comments.

Dr. BAILY. One can exaggerate the similarities with the Kennedy tax cut. I agree with the point that you made that 91 percent is a pretty absurd rate of tax. It was actually appropriate to cut that rate; 70 percent was still pretty high. Once you get up to 91 percent, you're going to get some distortions. Bringing that rate down is a very appropriate thing to do.

The parallel being made is that tax revenues rose after the tax cuts were enacted. This was because the economy had been in a recession in the early 1960s—there was a double-dip recession—and as it recovered, there was high growth in the economy. It may well be also, going from 91 to 70 percent, that there were effects on the incentive side. Most of what happened was the cyclical strength, which then went too far as expenditures on the Vietnam War increased and the economy became overheated.

The tax rate reductions that are being proposed now, to the extent they have incentive effects, those would be substantially smaller. But on the overall point: We should set our tax rates with an eye to what's the reasonable burden that people should pay relative to what the level of spending that has to be financed. The incentive effects, most careful analysis suggests, are fairly small to making moderate adjustments in tax rates.

Mr. GLASSMAN. I'm not sure if the implication of your question is that the Bush tax cuts are too small. I would probably agree with that. Certainly the Kennedy——

Mrs. MALONEY. I think he answered it pretty clearly. Would you say a reduction in the estate tax, do you feel that would be an effective economic stimulus?

Mr. GLASSMAN. It's not on the top of my list. In other words, I don't think the estate tax has a big economic effect. It has some. The main effect is a lot of money flowing to lawyers and accountants so that people can set up a system where they don't end up paying the tax. It's very inefficient—one of the many inefficiencies in the tax code.

Mr. KUDLOW. It's in the second tier of my wish list.

Mrs. MALONEY. What effect do you think cutting the estate tax would have on the economy? Do you think it would be an economic stimulus?

Mr. KUDLOW. Yes. I think it's pro capital formation, absolutely. I think the measuring those effects, however, are not easy, because so many people today don't pay because of what Jim said, you've got the diversion of accounting and legal financial planning industry, which is there precisely to set up, I might add, highly successful avoidance schemes.

I just wanted to mention on the question you asked Dr. Baily, you and I have gone back and forth on this for many years, lower marginal tax rates are lower marginal tax rates. And what President Kennedy proposed is, in terms of structure, identical to what

President Reagan later did and what President Bush is doing. And I might add what President Clinton did in the mid-1990s. Income distributions are different, inflation rates are different, tax brackets and so forth are all different. But lower marginal rates are lower marginal rates. And Coolidge, Kennedy, and Reagan and Clinton did it in the 20th Century. Every time economic growth followed.

Mrs. MALONEY. But after the Reagan tax cuts, Mr. Dole came forward and had to increase taxes, because the deficit was going up and was reacting to cuts that were too much.

Mr. KUDLOW. The deficit went down.

Mrs. MALONEY. And possibly we would have Republicans having to raise taxes if this $1.6 or $2.2 trillion goes through.

Mr. KUDLOW. Well, you and I might disagree about the history of the 1980s.

Mrs. MALONEY. Did Mr. Dole raise taxes roughly $300 million after the Reagan tax cuts?

Mr. KUDLOW. We did not change income tax rates. That's the important point. Income tax rates were lowered in the 1981 bill, implemented over a 3-year period and they were never raised. No.

Mrs. MALONEY. Well, where did the Dole tax increase come from?

Mr. KUDLOW. The Dole program, and I don't want to single out Senator Dole, he didn't have that much power in those days, no Senator does. But the fact is, payroll taxes were raised and some shifting about in the original corporate tax cut is changed. In other words, the safe—releasing was repealed and certain depreciation reform was repealed. The individual income tax rates, which were brought down, were never raised. And I might add, from the full implementation, which was January 1st, 1983, each and every year individual income tax receipts rose. The non-payroll individual income tax receipts rose every year.

Mrs. MALONEY. My time is up.

Chairman KING. Mr. Shays.

Mr. SHAYS. Mr. Greenspan said that he supported a trigger for surprising—tax cut and I don't want to—he said what about spending? He said, well, he would support a trigger on entitlements.

Is there logic to actually—I don't support a trigger, but if you had one, couldn't I do the inverse and basically say, you've got a great surplus that we need to accelerate the tax cut? And if I did that, what would be the negative?

Mr. KUDLOW. Well, I mean, that's an interesting model, actually. I had considered that. There probably is merit to that. Because I think the lower tax rates, if we're going to get better here on the probe and that's actually going to throw up higher surpluses which permit a greater tax reform in the next decade.

Mr. SHAYS. Mr. Glassman.

Mr. GLASSMAN. I agree with what Larry said. I mean, I'm not for a trigger, that's for sure. I think it limits your flexibility among many other things, but, if you had one, that's not a bad idea.

Mr. SHAYS. Dr. Baily.

Dr. BAILY. I'm not too enthusiastic about triggers. The concern about a trigger would be that if the economy were perhaps beginning to overheat at some future point, it might at that point be throwing off larger surpluses. That's part of the automatic stabilizer mechanism that helps to prevent that overheating. So if you were to trigger greater tax cuts, this would be the wrong policy. Similarly, if the economy would go into a deep recession, the surpluses would disappear. I don't think that would be a good time to increase taxes.

Mr. SHAYS. I realize this isn't the Ways and Means Committee, but if I asked, in terms of the most important as it relates to taxes, stimulus, fairness, inefficiency or—to get it off the table, get the money off the table.

Mr. KUDLOW. Stimulus.

Mr. GLASSMAN. I think I would go for number four first. I would say get the money off the table, and then I guess I would say stimulus and then efficiency and fairness is a five.

Mr. SHAYS. Fairness is the easiest one for us to argue for our constituents, so I'm sorry.

[Laughter.]

Mr. SHAYS. Dr. Baily.

Dr. BAILY. I would think efficiency and fairness would be the two I like.

Mr. SHAYS. I will yield back. Thank you.

Chairman KING. Dr. Paul.

Dr. PAUL. Thank you.

I think a good marginal tax rate ought to be about 10 percent. Any person who has to pay more than that—10 percent, let's give them 10 percent and then let's work on it. But, of course, that involves a spending problem. I want to get back to money policy and deflation. I was looking at Mr. Kudlow's chart that he gave us, and it shows that the monetary base, the reserves monetary base was rising at a 17 percent rate a year ago and it evened out and now is at 4 percent. So I would not call that deflation. And the rapid rise a year ago, so we have a lot of cash floating out there.

To me, deflation is what happened in the 1930s. The supply shrinks, the purchasing power of a dollar goes up. By all measurements the supply is going up, the purchasing power of our dollar is going down. And commenting again on the panacea that everybody looks to that all we have to do is get the lower rates and we're going to solve our problem. Just like the seven increases in rates in 1994-95 did not give us a recession, sometimes the lowering of the rates won't do what they did the last time.

For instance, interest rates are 0 percent in Japan because we're not getting a stimulus. As a matter of fact, after the depression got going we took interest rates very, very low and it was the old story about pushing on a string, it doesn't always work. So I do think that this concept of money and market policy is still very, very important, because I believe it's the mistakes made previously that gives us this mandatory correction, to me that just makes the bubble that much bigger.

But I do want to follow up on a comment Mr. Kudlow made on the indicator of the gold price. And I think that the gold price could give us a good indication of what was happening, except that the gold price is not controlled by the marketplace. In the 1960s, we maintained the gold price at $35 an ounce by dumping gold. Therefore, the gold price was no indication at all about what was to come in the 1970s. Finally they quit dumping the gold on the market.

Today, gold is being dumped on the market in a different way. Central banks are loaning that gold, that gets dumped on the market. And some of those funds are used to buy Treasury bills, it props up the dollar at the same time it drives the price of gold down. Britain and other countries have literally sold hundreds of tons of gold into the market. So I would ask whether or not you think this is really a good number to follow, a good price to follow, indicating what the market is telling us.

Mr. KUDLOW. Well, I wouldn't bet the ranch on any one indicator. But gold holds up pretty well over time. As I mentioned, in the last 20 years, the weight of the direction of gold trends has been deflationary, not inflationary.

I agree with your other point on interest rates. I mentioned that in my opening remarks, interest rates don't tell you much about monetary policy.

However, if you examine that chart I'm glad I got somebody to take note of that monetary based chart. Going from 16 percent growth over a 12-month change to minus 2.5 is one of the biggest swings in post-war monetary history. And, by the way, going on the other side, going from 5 to 6 percent of 16 was an inflationary swing in 1998 and 1999. But going from 16.5 to minus 2.5 in 12 months ended in December 2000. That's exactly what we're paying for in this economy. And to say that base growth now has jumped a little bit back to 3, 4 percent, I don't think the Fed's job is nearly done. And I think somebody with a higher paid rate in mind need to evaluate how this all developed, because when the monetary authorities come before Congress, they do not talk about this.

Dr. PAUL. I think this makes my case that no Fed official, bureaucrat nor politician knows how to manage the money supply—they're incapable of doing it. And I think these swings indicates it. And we have probably too much faith in an individual knowing, well, what is the proper interest rate, what is the proper money supply believing that they know how to turn the spigot on and off. I contend that it's something not known and that this has to be decided by the marketplace, but we have given up on the market for one half of our economy, and that's the money system. And that dictates everything. So we are central planners through the control of money supply and interest rates, so we are much more into central planning and Greenspan is the biggest central planner. So when things go well, he's a saint and when they go badly, you know, he's the devil.

Mr. KUDLOW. Well, I have made some of the same points, Congressman. But I will say this, since we have a Fed and the Fed is vested with the authority of open market operations, we need to look at what they're doing.

For some reason, and I'm a keen student of the testimonies of central bankers before Congress, for some reason, no one goes down this road; no one looks at these issues. Members talk about taxes, the budgets, and deficits, and debts and triggers and all the rest of it, but there's never any discussion about money, which is after all what the Fed controls. And, as you know, there's only one interest rate the Fed controls. Well, I'm sorry, two. They control the discount rate and then they mostly control every other interest rate in the economy is not controlled by the Fed. But what they do control is the creation of bank reserves. And I wish you would look at that.

Mrs. MALONEY. That's subject matter for another hearing.

Dr. BAILY. Can I make a quick comment on that? Let me first of all correct an impression that I may have given in thinking that the Fed does it all. That's not my view. The Fed leans against the wind. There are natural forces in the economy that give rise to ups and downs. Recovery begins as inventories are reduced.

And the other comment is on the change in the financial system. The changes taking place in the financial system, and the deregulation of the banking system, have made the money supply a much less useful measure and that's why most people look primarily to the effect of interest rates.

Chairman KING. I would like to thank the entire panel for their testimony. Again, as the debate goes forward, I would hope that everyone would look at the your comments today, your testimony which added immeasurably to the debate. And so I just want to thank you for your time and being here.

I just want to note some Members may have additional questions for the panel that they may submit in writing. Without objection the hearing record will remain open for 30 days for Members to submit questions to the witnesses and place the responses in the record.

The hearing is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

A P P E N D I X

March 29, 2001

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Domestic Monetary Policy, Technology, and Economic Growth
March 29, 2001

"Beyond the Tax Cut: Unleashing the Economy"

Thank you Chairman King.

I want to commend you on holding this important hearing as your first meeting of the Subcommittee on Domestic Monetary Policy, Technology and Economic Growth, and on assembling such a stellar roster of witnesses.

Majority Leader Armey, we remember your career as an economics professor. Thank you for taking a break from the Capitol to share your thoughts on economics with us. Welcome to the new Financial Services Committee, we're working hard to make you and the rest of our leadership proud of your decision.

I also want to welcome my friend Jim Glassman. Jim, I miss your columns in the Washington Post, which I thought were insightful and easy to read.

Mr. Kvamme, we look forward to hearing what you had to say to President Bush yesterday. Congratulations on your recent appointment as "technology czar" for the White House.

It seems that Larry Kudlow is on every cable television show except for "The Sopranos." I expect he'll make a guest appearance there very soon.

And, we are pleased to welcome to Dr. Martin Baily, senior fellow at the International Institute for Economics.

We face a puzzling economic situation. Part of our uncertainty is a result of the resounding economic success we have achieved over the last two decades. Yet, in many previous decades of the last century, even our current situation would have been a great blessing. This is a country that has become used to fabulous stock market returns, low unemployment, and low inflation.

Understandably, people have gone from exuberance to anxiety about the stock market's performance of recent weeks, and yet so many fundamentals of our economy remain strong. Consumer confidence remains high. Consumer prices outside of energy, inflation in general, and unemployment remain flat. Despite these positive signs, industrial production has fallen for five months in a row. All indications show that we are at zero growth or very slow growth, and that's not good enough.

The Financial Services Committee, and Mr. King's Subcommittee, have jurisdiction over economic growth and technology. So, we are in a unique position to look at the big picture and ask what can be done to support to weak areas of our economy. Peter King is to be commended for asking the big question that has no easy answer.

Clearly, a retroactive, across-the-board tax cut is in order to provide short-term stimulus. But we also need marginal rate cuts that will be predictable and long-term, allowing both families and businesses to make long-term economic and business plans. I believe that capital gains tax cuts would help do the job and would more than pay for themselves.

But beyond tax cuts, there are many other aspects of the economy that must be addressed.

This economy runs on energy. If we do not find new sources to meet our energy demands, we will fail to achieve our full economic potential. Utilities are among the most capital intensive in America, and this Committee intends to look after our nation's capital formation ability.

Regulations continue to hold back the American economy. These excess costs are particularly burdensome to companies in a downturn. So right now, companies' ability to absorb every whim of Washington is limited.

The United States is a great market, but the real growing potential markets for our companies are Third World and developing countries. I was pleased to hear Majority Leader Armey's call to fast-track fast-track yesterday.

As our nation's high-tech leaders told the President yesterday, we must identify impediments to the development of capital for our existing and new companies – particularly for small and entrepreneurial companies, which generate three-quarters of all new jobs in this country.

Over the last decade, the American economy has expanded like never before because of the brilliance of engineers and scientists who've created the computer and electronics revolution. Some would say now that too much money was poured too fast into the tech sector, but I would argue that the rush of the past few years pushed the innovations farther and faster than otherwise would have been possible. This boom occurred not because of government, but often in spite of it. We do know that government can help, by cutting taxes and removing government red tape, and that is this Committee's mission.

To all of our witnesses, I look forward to your testimony and your ideas for solving these puzzles.

14th District • New York

Congresswoman

Carolyn Maloney Reports

2430 Rayburn Building • Washington, DC 20515 • 202-225-7944
1651 Third Avenue • Suite 311 • New York, NY 10128 • 212-860-0606

Rep. Carolyn B. Maloney
Ranking Member
Subcommittee on Domestic Monetary Policy, Technology, and Economic Growth
March 29, 2001

This morning the Subcommittee considers the topic: "After tax cuts: unleashing economic growth." While I plan to raise a number of issues, I must comment on tax cuts, as I believe the Majority's proposals, one of which is currently being considered on the floor, constitute some of the greatest challenges to sustaining economic growth by threatening a return to large deficits and higher interest rates.

First the facts: One, the Majority's tax cut is so large and based on economic assumptions that can vary so greatly that we risk deficits if our numbers are only slightly off. CBO, whose rosy projections are the basis for the tax cuts, indicated that its average error margin in projecting budget surpluses or deficits for a fiscal year *in progress* has historically been about 0.5 percent of the Gross Domestic Product (GDP). In the current economy this would be $54 billion in one year. As for projecting five years out, CBO's average error has been 3.1 percent of GDP, a six-fold increase. To borrow a Bush catch phrase, making ten-year projections is truly "faith-based" budgeting.

Second, despite the current surplus the federal government is enjoying, danger lies just over the horizon. The uncertainty of the next ten years is trumped by the certainty of the second ten. Starting in the later half of this decade the baby boomers will begin to retire, drastically increasing our entitlement commitments. Should we find ourselves facing deficits in 2008 we will truly be in a dire predicament.

Third, as we all know, the economy is slowing and the President's supposedly $1.6 trillion tax cut, which is actually closer to $2.2 trillion when interest not paid on the debt and the necessary AMT fixes are included, was not conceived as an economic stimulus. It was a campaign package constructed two years ago to appeal to Republican primary voters. It will have little immediate impact and in fact 75 percent of the promised tax cuts come in the second five years. The Majority may claim to want to end the marriage penalty, but as some of my Democratic colleagues have pointed out on the floor, their plan is more like a tenth anniversary present.

While I could go on about this ill-conceived tax package, let me simply say that Democrats support tax cuts and we could easily have bipartisan consensus for a historically, large, fair and immediate tax cut that would be supported on a bipartisan basis and passed in days.

Looking beyond the Majority's flawed tax cut, there is a great deal Congress can do to spur economic growth. The Federal government plays a critical role in encouraging research and development in the private sector. This is especially important to technology companies that have been the engines of growth in the last decade. We must also increase our commitment to the education of all of our children, especially those in public schools. I do not believe this is accomplished through any program that will merely subsidize some students by taking money away from public schools. Rather, Congress should commit to school construction and other reform measures.

Finally, I strongly favor, as part of a responsible tax cut plan, increasing IRA and 401k contribution limits and allowing for pension catch-up contributions. These provisions increase savings and catch-up contributions can be especially beneficial to women rejoining the workplace later in life.

I believe the Congress can make major positive contributions to economic growth, I only fear that the Majority's plan commits almost all of our expected future surplus to a long-term tax cut that would do nothing for the economy now and would take away our flexibility to deal with future economic needs as they arise.

House Financial Services Committee Hearing "Beyond the Tax Cut: Unleashing the Economy"
March 29, 2001

Statement by:
E. Floyd Kvamme, Partner, Kleiner Perkins Caufield & Byers

Mr. Chairman, I am pleased and honored to have the opportunity to testify before the committee on the issues of tax policy and capital formation and to submit these written comments. This hearing could not come at a more propitious time given the current challenges our economy faces in the area of capital formation. Weakening economic performance and a greatly devalued stock market have significantly inhibited, and will further erode, the ability of our capital markets to allocate the necessary resources to fund growth in our economy and maintain our international competitiveness.

I am a General Partner at Kleiner Perkins Caufield & Byers in Menlo Park, California; we are a high technology venture capital firm, and, in that capacity, I serve on the board of directors of seven high technology companies. I also serve as Chairman of Empower America, a Washington based issue advocacy organization; on the board of the Washington based National Venture Capital Association and on the Executive Committee of the Technology Network, a network of about 280 high technology firms with headquarters in California but with members from across the country. My testimony today, while influenced by each of these associations, represents, however, my personal view on steps that could unleash the economy.

Mr. Chairman, as you know, the venture capital industry has been a catalyst for much of our economy's remarkable and consistent growth in the past decade. My colleagues and I have invested in the ideas and people that have fundamentally changed our economy and the ways in which we live and work. We have provided the necessary capital, mentoring and guidance to help high growth companies realize their potential in the burgeoning areas of information technology, telecommunications, biotechnology, the Internet, and beyond.

The growth our industry has experienced during this time has been nothing short of superlative. What used to be a relatively small, regionally based community of investors has expanded into a large, nation-wide industry. The skills of talented entrepreneurs and managers backed by venture professionals has translated into successful investments that have greatly increased interest among the investing community in this asset class and has provided significant returns to the pension funds, foundations, university endowments and other organizations that are our limited partners.

These investments do not merely build high growth companies, they are helping to introduce and integrate critical technological innovations that are being applied everywhere in the economy. According to recent studies published by the Federal Reserve Board, the application of information technology throughout industry over the past decade has vastly increased labor productivity. The abstract of a Board paper entitled, "The Resurgence of Growth in the Late 1990s: Is Information Technology the Story?" succinctly makes the case:

> *"The performance of the U.S. economy over the past several years has been remarkable, including a rebound in labor productivity growth after nearly a quarter century of sluggish gains...Our results indicate that the contribution to productivity growth from the use of information technology — including computer hardware, software, and communication equipment — surged in the second half of the 1990s. In addition, technological advance in the production of computers appears to have contributed importantly to the speed-up in productivity growth. All in all, we estimate that the use of information technology and the production of computers accounted for about two-thirds of the 1 percentage point step-up in productivity growth between the first and second*

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halves of the decade. Thus, to answer the question posed in the title of this paper, information technology largely is the story."

I am very proud of the role my industry has played in this story. Today, however, we are presented with the challenging question of how to keep this engine of productivity and economic growth going. As such, I am pleased to offer my comments on what steps can be taken to help entrepreneurs and others in industry to continue to innovate and build our economy.

An important first step to economic growth is already being taken. President Bush's tax relief proposal, which is advancing through Congress, is critically important to both the short-term and long-term growth of our economy. Reductions in marginal tax rates and the elimination of both the estate tax and marriage penalty will release much needed capital into the economy and lead to still greater productivity. I applaud the steps you and your colleagues are taking to enact the President's tax package.

Once the President's tax relief proposal is enacted, I strongly urge you to consider more comprehensive tax and regulatory reform effort focused on sustained economic growth and security. Below, I offer some of my specific thoughts:

Access to Capital:
The number one priority of emerging growth companies is and always has been sufficient and efficient access to capital. Congress has taken important steps in the recent past to help in this area, most recently in 1997 when it lowered the capital gains tax rate. Our industry believes that further efforts to lower the tax rate are necessary to the long-term health of our economy and international competitiveness. U.S. investors (who are now half of U.S. households) face capital gains tax rates on both short- and long-term gains, which are among the highest in the industrial world. While long-term gains for individuals are taxed at a top federal rate of 20 percent in the United States, the average tax rate in the other countries is only 14.8 percent. The short-term capital gains rate differential between the United States and its competitors is even greater: individual U.S. investors face a top federal rate of 39.6 percent compared to an average of only 18.4 percent overseas. Closing these differentials will significantly enhance the incentive within our country to buy, hold and sell equity instruments for individuals and corporations.

Interestingly, if the past is any predictor of the future, every time the capital gains rate has been reduced, revenues from taxation of capital gains have increased. Capital gains tax relief would also increase worker productivity and allow wages to rise without inflation. Finally, capital gains relief will raise the after tax return on capital making it more attractive for people to invest in start-up companies, which fuel economic growth and innovation.

In contrast to this focus on capital formation, I'm advised that there, unfortunately, appears to be some support for a $60 billion cash-tax rebate check that is unconnected to more comprehensive reform. There is substantial evidence from experts that one time tax cuts do not substantially help an economy. The cash-tax rebate plan is aimed at temporarily bolstering consumer spending. But as ING Barrings Chief Economist Larry Kudlow points out, personal consumption expenditures are the strongest part of today's economy. For example, in the current quarter, for which real GDP will be reported in late April, real consumer spending could rise by 3.25%. In stark contrast stands investment spending, in the form of diminished stock-market purchases and business equipment expenditures, which has declined substantially pulling down the entire economy.

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As a result, we should focus on increasing capital investment as a means of restoring the economy to health. Far preferable to any kind of rebate would be for Congress to provide a front-loaded acceleration of the across-the-board marginal tax rate reductions to January 1, 2001 as proposed by the President.

On a smaller but more immediate scale, small business access to capital can also be enhanced through a regulatory clarification that will fully implement legislation Congress passed several years ago. Section 1045 of the Internal Revenue Code allows taxpayers other than corporations that dispose of qualified small business stock (QSBS) (as defined in section 1202) held more than six months to defer tax on the sale of those assets if they invest the proceeds in other QSBS within 60 days of that disposition. In 1998, Congress amended Section 1045 to make clear that taxpayers holding stock through a partnership could qualify for the benefits of that provision.

Unfortunately, Section 1045 is silent regarding how partners can obtain rollover benefits in the context of a variety of very common transactions involving partnerships. For example, virtually all venture managers and most venture investors hold partnership interests in a number of venture capital partnerships. No guidance is available, however, with regard to how a partner's share of gains attributable to one partnership's disposition of QSBS can be rolled over if another partnership, to which that partner has contributed capital, makes a timely investment in other QSBS. Issuing regulations will fulfill Congress' legislative intent and increase access to capital by our high growth companies.

Encouraging Savings:
Congress and the president could pass positive pro-growth tax relief such as increasing the limits and lift the caps on IRAs, Roth IRAs and 401(k) retirement accounts. That is a better way for America to save than by running huge and persistent budget surpluses.

Regulation of High Tech & Biotech Industry:
Congress should remain ever vigilant to guard against the growing regulatory morass that is encroaching on the high tech and biotech industries. This concern applies to a number of fronts from rules on communications technology that were developed in another age to the arcane manner in which export licenses must go through as many as five agencies to gain approval.

It is critical for policy makers to realize that the strength of our high tech and biotech sectors lies in their ability to be flexible in responding to changing technology and market conditions. With product life cycles becoming ever shorter, issues of importance to these sectors arise quickly and demand immediate attention. Because of its slow moving nature, government policy-making simply is not equipped to respond to many of these concerns in a timely fashion. Often times, a late or misguided government response will do much more harm than good.

Excessive regulation of any particular industry increases the investment risk and thereby lowers that industry's access to adequate capital. I would urge Congress to respond to industry concerns regarding unnecessary and inhibitive regulations that serve little or no purpose other than to lessen the efficiency and competitiveness of our high tech and biotech sectors in the global marketplace. It is important to remember that the American high tech industry leads the world in virtually every area of competence and produces nearly half of its revenue from export sales to the further benefit of the American economy. To my knowledge, there is no such thing as a high-growth regulated industry. Continued leadership for American companies could be threatened if regulations restrict the freedom of action that the industry has enjoyed to date.

Other Issues of Importance:

House Financial Services Committee Hearing "Beyond the Tax Cut: Unleashing the Economy"
March 29, 2001

Congress will play a key role on many other issues that will affect the growth of the high tech and biotech sectors and the expansion of our economy. In order to assure that these sectors are financially healthy and have adequate access to capital, I would urge Congress to pursue pro-growth policies in the following areas:

- Free trade: open and fair access to foreign markets is critical to the success and growth of these sectors. As just mentioned, the average annual export sales as a percentage of revenue for a typical venture-backed company grows from zero to 43 percent in the early years of the company's life. In order to expand these overseas opportunities for growth, our industry strongly supports extending Trade Promotion Authority to President Bush.
- Efficient stock markets: secure, flexible and efficient stock markets are essential for high growth, venture-backed companies to grow to the next level after the venture capitalist exits his or her investment in the company.
- Effective patent and copyright protection: intellectual property is the lifeblood of venture-backed high tech and biotech firms. Secure protection of IP rights is prerequisite for investment in a start-up. Assuring an efficient and equitable patent and copyright processing system is a priority.
- Workforce/education issues: access by venture-backed firms to skilled and well-trained workers is critical to the success of these companies. Investment decisions are often made in part on the basis of an entrepreneurial firm's line-up of managerial and technical talent. Thus, our industry commends Congress for increasing the availability of H-1B visas last year. At the same time, we recognize the great need to reform our education system and we look forward to working with President Bush and Congress on the education proposals and workforce training legislation that will advance educational opportunities for all Americans. The fact that we need 195,000 H-1B workers while our universities are graduating only some 45,000 engineers per year points to the dramatic need for education reform.
- Congress could eliminate the three-year write-off period for software and allow companies to expense the cost of software immediately; make permanent the R&D research tax credit; and cut taxes that that pose as obstacles to broadband deployment and the productivity gains it would produce.

The President's plan, along with these pro-growth tax initiatives and a cooperative monetary policy will help stimulate the economy and set the stage for the next phase in the president's economic plan. After getting the economy back on a growth trajectory, the president will be free to provide a comprehensive vision for the future of the American economy.

The vision would essentially consist of the reforms President Bush has already articulated. The administration and congress should forge ahead as quickly as possible to reform Social Security into a payroll-tax-financed worker-investment and personal retirement account program by allowing workers to invest a significant portion of their payroll taxes into personal retirement accounts.

Again, I am honored and pleased to be before your committee to discuss these vitally important issues. Although there is much work still to be done to implement the President's tax relief package, I commend you for your leadership in beginning the discussion of the next steps to be taken in order to enhance our economy's growth and efficiency.

Liberate Supply

Testimony before the Subcommittee on Domestic Monetary Policy,
Technology, and Economic Growth
of the

Committee on Financial Services
of the
United States House of Representatives

At a hearing entitled
"Beyond the Tax Cut: Unleashing the Economy"

By James K. Glassman
Resident Fellow, American Enterprise Institute
Host, www.TechCentralStation.com

American Enteprise Institute
1150 17th St., N.W.
Washington, D.C. 20036
(202) 862-7198 jglassman@aei.org

March 29, 2001

Mr. Chairman, Members of the Committee:

My name is James K. Glassman. I am a resident fellow at the American Enteprise Institute for Public Policy Research in Washington, D.C., and host of www.TechCentralStation.com, which concentrates on issues of technology and public policy. I am also a senior consultant and chief columnist to Folio(fn), a financial services company that packages and markets portfolios for investors. My writing on financial and economic matters appears regularly in the Wall Street Journal, International Herald Tribune and other media, and I am co-author of *Dow 36,000*, a book on stock valuation. For six years, I was a columnist for the Washington Post. Prior to that, I was editor of Roll Call, the twice-weekly newspaper that covers this institution; publisher of two public affairs magazines, the New Republic and the Atlantic Monthly; and host of two television series, "Capital Gang Sunday" on CNN and "TechnoPolitics" on PBS.

My main area of academic interest is the nexus among technology, finance and public policy.

The message I bring you today is that the U.S. economy has slowed and that tax cuts and monetary easing are necessary but not sufficient to restore the rate of growth we experienced in the late 1990s. What is critical is that changes are made in regulatory policy to encourage a liberation of supply – a resurgence of output. I will give specific recommendations on how this can be accomplished. First, however, I will briefly review the state of the economy; offer observations on why it has slowed; and present an analysis on why it has grown with such strength over the past decades.

State of the Economy

The United States economy has slowed significantly in recent months. The growth in Gross Domestic Product (GDP), the nation's output of goods and services, fell from 5.6 percent in the second quarter to 2.2 percent in third quarter to 1.1 percent in the fourth. Retail sales and job growth are flat, unemployment is rising, the critical Purchasing Managers Index has dropped by one-fourth in the past year, a majority of banks has tightened credit requirements for businesses, and industrial production has dropped for five straight months.

The high-technology sector has been hit especially hard. For example, Cisco Systems, the giant Internet infrastructure provider, was increasing its revenues at a 70 percent pace as recently as November. But by February, sales were actually *down* from the previous year. "This is important," writes economist Brian Wesbury of Griffin, Kubik, Stephens & Thompson, Inc., who then quotes Alan Greenspan, the Fed chairman, as saying on March 27: "High-tech goods – semiconductors, computers, and LAN equipment...contributed two-thirds of the increase in manufacturing output between 1995 and 2000." Overall, electronic goods orders are off 4 percent over the past year. Meanwhile, the authors of a new study estimate that 80 percent of the remaining dot-com companies in the San Francisco Bay will collapse in the next year. Profit expectations for the companies of the tech-heavy Nasdaq have fallen 75 percent. We may already be living through the beginning of the first recession in 10 years; we will know for sure when the statistics are published in a few weeks.

The 1990-91 recession, which ran for nine months, was considered mild by historic standards. At its depth, the economy's output declined only 1.5 percent. Still, it is important to remember that even short and shallow recessions hurt. In the last recession, the unemployment rate rose from 5.4 percent to 7.8 percent (by the summer of 1992, after the recession had officially ended). It was not until December 1994 that unemployment returned to its pre-recession level. If we have a typical recession, three million Americans will lose their jobs. Also, even if we are not in a recession today, it feels like one. GDP growth has dropped from an average of about 4 percent to about 1 percent. That is roughly the equivalent of a decline from a GDP increase of 2 percent to a GDP *decline* of 2 percent.

Causes of the Slowdown

Today's slowdown has no single cause. These are the major culprits:

- **Fed rate hikes.** The Federal Reserve began raising interest rates in June 1999 with little sign of inflation. Instead, the central bank appeared to be reacting to high growth and to a buoyant stock market. The real, after-inflation, rate on federal funds, the overnight loans that the Fed targets, reached a peak of 5.1 percent in October 2000, the highest rate since September 1989 – a year before the last recession – constricting the flow of capital.

- **Tripling of oil prices.** Eight of the nine post-World War II recessions, including the last four, have been preceded by an oil shock. It is the rising oil price **plus** tighter Fed policy that tends to cause recessions, and this double whammy is present today as well.

- **The drag of high taxes and a gigantic surplus.** Federal tax revenues as a percentage of GDP last year were 20.6 percent – a level exceeded only twice in U.S. history, in 1944 and 1945. The surplus itself is a reflection of these high revenues flowing into Washington. Cash that could have been used for consumption or new private investment is instead being used to retire the bonds of investors who typically use the proceeds to buy more bonds. Retiring debt – especially with debt at such low levels (about one-third of GDP) is no way to spur an economy. (I respectfully refer the committee to my article, "The Joy of Debt" in the March 26, 2001, issue of The Weekly Standard.)

- **The end of the high-tech "enterprise zone."** The past year, especially, has seen increased government intervention in the economy, especially in the high-technology sector and federal and state mismanagement of the planned deregulation of telecommunications. A year ago, I argued that this change in political approach to high tech threatened a "regulatory recession." We may be in it. It is no coincidence that high-tech stock prices began their 60 percent slide at almost the same moment that the Justice Department asked a federal court to break up Microsoft Corp., the software company that is credited with igniting the computer revolution in the early 1980s. While the antitrust suit against Microsoft was instigated by its competitors, the result has been to damage the capital-raising ability of nearly every high-tech firm – and to encourage further interventions at federal, state and local levels, threatening to end the status of high tech as a kind of "enterprise zone," free from high taxes and onerous regulation. In telecommunications, the persistence of monopoly power in local markets has greatly deterred the rollout of broadband technology and deferred indefinitely much of the promise of the Internet.

Why the Economy Boomed

Before getting to the question of what must be done to reverse the slowdown, we need to examine why the economy has been so successful up to now. The U.S. is in the tenth year of an unprecedented expansion. Even if the recession did start in January, the economy will have grown a full year longer – without respite – than in any period since reliable statistics began to be gathered in the 1870s. The third-longest expansion (and the second-longest during peacetime) was the period that immediately preceded the brief 1990-91 recession. In other words, since July 1982, the GDP has increased consistently, with a nine-month exception. No economy in the world has seen such a boom in output and accumulation of wealth in so short a period.

Since World War II, there have been nine recessions in 56 years, but in the past 18 years there has been just one. Has the business cycle been repealed? That cycle works like this: Low unemployment and prosperity raise the demand for goods and services. This rising demand inevitably bumps up against supply, gets tangled in bottlenecks. With supply constrained, prices rise, and general inflation ensues. The Fed, whose job it is to prevent the depreciation of the dollar and to maintain financial stability, raises interest rates to whack down inflation. The economy slows and frequently goes into recession. Interest rates fall, the economy revives, and the cycle begins all over again. But in the 1980s and 1990s, this pattern did not hold. Strong growth – at times more than twice the post-war average -- was accompanied not by rising inflation but by relatively stable prices.

Why?

The reason is that the U.S. has been undergoing what I call a "liberation of supply." When demand rose, it did not bump up against supply constraints, so prices remained tame. In a broader sense, capital and the other tools necessary for an entrepreneurial expansion were all in place, so the economy boomed. What were the factors that liberated supply? Here are the primary ones:

- **The spread of free trade.** When bottlenecks occurred in this country, goods from other countries took up the slack. In addition, the U.S. has been helped by immigration (free trade in people, especially in high technology) so that labor shortages were milder than usual. And, at the same time, a financial revolution helped liberate capital and spread it around the world, with investors seeking the best place to deploy their funds – often, the United States, with its relatively accommodating business environment.

- **Lower tax rates and new regulatory policies**. Before Ronald Reagan's election in 1980, the top rate on income was 70 percent. It was cut 28 percent, but, even at today's top rate of 39.6 percent (which applies to nearly all decent-sized private proprietorships and partnerships), it is far lower than in the 1970s (though still too high). Low taxes encourage more work and investment – that is, more supply. At the same time, the government began a series of deregulatory measures, beginning with transportation in the Carter Administration and extending to energy and telecommunications. This work is far from done, but the change helped remove supply constraints.

- **Better monetary policy**. The Fed has learned a lot since the 1930s, when three successive chairmen presided over tight-money policies that exacerbated the Depression. Paul Volcker, with the backing of President Reagan, had the courage to ring inflation out of the economy, and Alan Greenspan has continued those policies. The next Fed chairman can be expected to do the same, keeping interest rates low and encouraging investment and the liberation of supply.

- **The high-tech revolution.** The advent of inexpensive, powerful networked computers has boosted productivity – the main component of economic growth. From a rate of less than 1 percent in the 1970s, productivity averaged 1.7 percent between 1982 and 1995, and a remarkable 2.9 percent over the past five years. Very simply, productivity means more output for the same input – that is, more supply. Why? Greenspan's own major contribution has been to recognize that information technology not only enhances the knowledge of businesses, it also reduces uncertainty – so that companies do not have to maintain redundancies in their workforce, inventories or plant and equipment, thus reducing inputs. As he said in a speech at Boston College on March 6, 2000:

> Before the quantum jump in information availability, most business decisions were hampered by a fog of uncertainty. Businesses had limited and lagging knowledge of customers' needs and of the location of inventories and materials flowing through complex production systems. In that environment, doubling up on materials and people was essential as a backup to the inevitable misjudgments of the real-time state of play in a company.... [Now,] fewer goods and worker hours are involved in activities that, although perceived as necessary insurance to sustain valued output, in the end produced nothing of value.

What Is to Be Done?
Tax Cuts and Rate Cuts

But lately, the liberation of supply has stalled. New bottlenecks and shortages have developed that threaten not simply to reduce growth but to raise prices as well, raising the specter of stagflation for the first time since the 1970s.

Two obvious steps are now being taken.

First, the Federal Reserve's Open Market Committee has reduced its target for the fed funds rate – from 6.5 percent to 5 percent. The Fed is likely to continue cutting through the spring and early summer, and a typical easing cycle would bring the rate to 3.5 percent, which should be enough to revive the economy eventually – though, as Milton Friedman long ago recognized, it takes six to nine months for rate changes, in either direction, to flow through the economy. It was not until last fall that we began to feel the impact of the rate hikes that started in 1999.

Second, Congress has begun action on President Bush's plan to cut taxes a total of $1.6 trillion over ten years. While this hearing is titled, "Beyond the Tax Cut: Unleashing the Economy," I want to emphasize the importance of significant tax relief. A short-term cut of $60 billion, as was recently proposed by some Senators, will give the economy little stimulus. Current GDP is $10 trillion. If half of the one-time tax rebate is consumed and the rest saved (a decent assumption), then increased consumption will represent just 0.3 percent of GDP. Or think of it this way: The CBO expects that tax revenues in fiscal 2001 will total $2.2 trillion. A rebate of $60 billion amounts to less than 3 percent of that figure. Even after such a rebate, tax revenues will still rise – assuming that the relief occurs wholly within the fiscal year – by some $41 billion for 2001, applying more drag to a declining economy.

If fiscal policy is to be used for short-term stimulus, then it must be far more aggressive. The surplus is expected to be $281 billion for fiscal 2001. A tax rebate of half that amount, retroactive to the first of the year and starting immediately, would have some sort of impact.

But such measures are diversionary and even counter-productive. Far more important for the long-term strength of the economy would be comprehensive relief in the form of reductions of marginal tax rates, across all brackets, as President Bush has proposed. Even if these reductions took place over time, they would immediately signal an important change to investors and consumers and would likely lead to more savings and investment and perhaps consumption as well. Also, in substance, cutting rates would spur entrepreneurship and investment by lowering the marginal cost of those activities.

A tax cut is the only sensible way to reduce the mounting surpluses, which will create a crisis of another sort by the year 2006, when the Congressional Budget Office forecasts that the federal government will accumulate $3 trillion in "uncommitted funds" – money that can't be used to pay down the debt because there will be no debt to pay down. Greenspan worries that these funds will be used to purchase private-company stocks and bonds – thus making the government a major player in the private markets and in corporate governance. Or the $3 trillion could, of course, be spent – since, judging from the budgets of the past two years, surpluses have loosened constraints on Congress and the White House.

Surpluses, in fact, are dangerous in times like these. My colleague at the American Enterprise Institute, the economist Kevin Hassett, pointed out in testimony Feb. 13 before the Ways and Means Committee that "the last time we approached a slowdown with restrictive fiscal policy, the economy responded to high surpluses and a general weakening in consumer demand by posting the steepest decline in real GDP in postwar history, dropping a whopping 10.3 percent (annual rate) in the first quarter of 1958. At the time, the surplus was about 1 percent of GDP." Currently, it is forecast to be three times as high.

Regulatory Reform to Spur High-Tech Supply

But resuscitation will require more than interest-rate cuts and tax-rate cuts -- though they are absolutely necessary. It will require regulatory changes that liberate supply once again. Specifically, these steps should be taken:

1. **The U.S. needs to formulate a clear energy policy that concentrates on encouraging supply.** Currently, supply is being severely hampered by excessive environmental barriers to increased exploration for energy and by policies, such as "new source review," that discourage the renovation of old refineries and utility plants and the building of new ones. We have neglected supply for ten years and are just now beginning to suffer the consequences. High technology requires energy, but supply constraints are putting the supply of energy in jeopardy. I recently returned from California, the heart of the nation's high-tech economy, where rolling blackouts are wreaking havoc with production. The rest of the nation may follow this summer.

2. **The antitrust policy of the later years of the Clinton Administration should be changed to take into account the realities of high technology**. I am referring especially to two phenomena: that monopolies and near-monopolies tend to be short-lived since barriers to entry for competitors are low and information about new software and other innovations spreads quickly, and that high-tech monopolists and near-monopolists, with low (often *no*) marginal costs, have an incentive to *increase* production rather than restrict it, as monopolists of the past did. The antitrust suit against Microsoft was the seminal event that changed the relationship between government and high technology and frightened investors. The decision by the Justice Department to go after a breakup of Microsoft coincided almost precisely with the peak of the Nasdaq and the beginning of its decline of nearly two-thirds in value. As George Bittlingmayer recently concluded after a historical study in a paper titled "Regulatory Uncertainty and Investment: Evidence From Antitrust Enforcement" in The Cato Journal (vol. 20, no. 3): "The low investment of the late 1950s and early 1960s was due at least in part to a resurgence of aggressive antitrust and related initiatives interpretable as 'anti-business.' Some of the low investment of the 1970s may have had a similar origin." Much the same is happening now to the high-tech

sector. Congress and the new administration have a chance to return to the course of the 1980s and most of the 1990s.

3. **The bottlenecks that are restricting the spread of broadband technology must be forced open.** The main problem is the lack of enforcement of the main piece of deregulatory legislation, the Telecommunications Act of 1996, which required the Bell monopolies to open up their systems to local competition as a condition for being allowed into long distance. But so far, after five years, in only four states have the Bells opened up enough to qualify. Meanwhile, mergers have produced a re-monopolization – the eight regional monopolies that control 95 percent of the local telephone business (the "last mile") are now just four. Because the Bells won't cooperate in opening their networks (preferring to use the courts and politicians to foster delays), competitors called CLECs, or competitive local exchange carriers, are cutting back their service or are going bankrupt. Rates for consumers are high – the opposite of the condition that prevails in competitive long distance. It's not a pretty picture. To bust the bottleneck, the Telecom Act must be taken seriously and, at the same time, state public utilities commissions should be encouraged to force "structural separation" on the Bells, requiring them to split into independent wholesale and retail units, so that competitors will get a fair shake. It sounds technical but it is the only answer to liberating telecommunications supply, allowing interactive businesses (many of which are now going under for lack of broadband) to prosper, and spreading the benefits of fast Internet connections to consumers.

4. **Wireless, too, is being hurt by a lack of supply.** Regulators should get out of the business of allocating bandwidth to the politically powerful and instead let market forces determine who gets space on the spectrum. Congress should auction the spectrum that it gave for free to the TV broadcasters in return for a promise – unlikely to be met – of a timely buildout of digital, high-definition television. And the Defense Department must stop hogging bandwidth. The Federal Communications Commission has been sitting on loads of spectrum in the 700-megahertz frequency band. Liberate it.

These four simple changes are for starters. Clearly, the federal Air Traffic Control system is another constraint on supply – in this case, the supply of fast consumer and freight transportation – that needs to be eliminated and replaced by a private, market-oriented ATC, with government oversight for safety only. Occupational regulations reduce output by raising costs for businesses. All such rules must be reviewed verify that their benefits exceed their costs. And state governments must reduce the threats – especially to technology and energy -- inherent in the collusion between state attorneys general and trial lawyers, especially those hired on a contingency basis.

Conclusion

The U.S. economy has shown that, when supply is liberated, growth rates of 4 or 5 percent – roughly double the post-World War II average – are possible, *without* inflation. With tax cuts, interest-rate cuts, a supply-oriented energy policy and sensible regulations, we can revive a prosperity that will improve the lives of even more Americans than the boom of the 1980s and 1990s.

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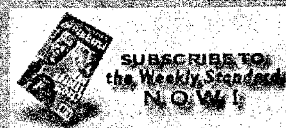


Article March 26, 2001/Vol 6, Number 27

The Joy of Debt

The last thing we should want is a U.S. Treasury flush with cash.

By James K. Glassman

Last Wednesday, investors, panicky over banking troubles in Japan, drove the Dow Jones Industrial Average down 300 points in the first few minutes of trading. Bloomberg Business News reported a worldwide "flight to quality"—from stocks into U.S. Treasury securities. But imagine if there were no such securities to buy. That's not such a farfetched notion. According to the latest estimates by budget experts, in five years, the market for Treasuries—the safest, most liquid, most popular investment in the world—will disappear.

Squirreled away on page xvi of the latest report of the Congressional Budget Office there's a very tiny but very scary graph. It shows a flat horizontal line at zero from the years 2000 to 2006, then a sudden soaring trajectory, like a cruise missile, blasting off at a 45-degree angle, then arching ever more vertically. By 2011, the graph shows the line exceeding $3 trillion, which is the equivalent of about $30,000 for every family in America.

The graph depicts something that has never happened before, in America or anywhere else in the world. It shows a government that has retired all the debts it can and begun accumulating vast "uncommitted funds"—a concept so new that the CBO had to invent the phrase. In theory, these surplus tax dollars will just sit there and sit there. In practice, however, they will be put to use. And that's the scary part.

One likely use of the money will be investments by the government (probably the Social Security trust fund) in private assets. This is the specter that worried Alan Greenspan so much that, as a way to forestall it, the Fed chairman switched his position and forcefully backed President Bush's tax cut. At a time when the rest of the world is privatizing state-owned companies, it would be ironic—and dangerous—for the United States to move in the opposite direction, with government ownership of shares or bonds issued by U.S. companies and (inevitably with such ownership) government control of those companies.

Greenspan told a congressional committee in January that "it would be exceptionally difficult to insulate the government's investment decisions from political pressures." The result, he fears, would be "sub-optimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living."

When the Clinton administration two years ago first proposed investing tax dollars in the stock market, the Senate unanimously passed a resolution opposing the idea. Certainly, government investing in private assets is a dramatic policy shift which, at the very least, needs to be debated publicly. We shouldn't blunder into it.

Another use of the money might be in new government programs—or an expansion of old ones. One salutary effect of the deficit was to prevent big new spending ideas from being funded. Was that so bad? During a decade of restraint, the unemployment rate dropped sharply, poverty and crime decreased, and the U.S. economy grew for the longest period in history. But already, the surplus has inspired both Democrats and Republicans to start spending again—at growth rates not seen since the 1970s.

A tax cut could prevent both of those consequences, but a cut of the size offered by President Bush—a total of just $1.6 trillion, phased in slowly, during a period when the federal government will be collecting about $25 trillion in taxes—is unlikely to be large enough or quick enough to prevent the scary graph from becoming reality.

The truth is that Washington is rolling in dough. There is so much cash flowing into the Treasury from tax revenues that every working day, on average, the federal government pays off another $1 billion in loans that it has made over the past three decades. The loans are in the form of U.S. Treasury debt securities—bonds, notes, and bills. In the past, when those securities matured, the Treasury (since it didn't have the money) would simply roll them over—that is, pay off the old bondholders and issue new debt, typically in a higher amount.

No more. In fact, in its latest report, the CBO estimates that "surpluses [will] exceed the amount of debt available for redemption in 2006." In other words, in five years, all the loans from the public that the government can repay will be repaid. And the money will keep flowing in; hence, the scary chart.

Even Greenspan seems to have been surprised that, at this rate, the Treasury won't have any retirable debt five years from now. Currently, the public holds about $3 trillion in loans to the federal government. But some of that debt is in the form of non-marketable securities, like savings bonds. Another $523 billion does not mature until after 2011. The Treasury has been offering financial enticements for investors to turn in those bonds, but the CBO—as well as the White House's Office of Management and Budget—estimates that very few of them will accept the deal. Why should they? As more bonds are retired, the remaining bonds become more scarce and thus more valuable. Greenspan, in his testimony before the House Budget Committee on March 2, said that investors who hold Treasuries do so because "they perceive them to be an extraordinarily valuable, risk-free, dollar-denominated . . . asset." They're right, and they aren't likely to part with such cherished objects. As a result, the CBO estimates that excess cash will start rolling into the Treasury, with nowhere to go, in 2006. And the OMB, for its part, sees those "uncommitted funds" starting to appear in 2004.

These are estimates, of course, and they may well be wrong. But it's important to remember that, in each of the past five years, congressional, presidential, and private prognosticators proved to be far too pessimistic about revenues. The key figure that determines future surpluses is the annual rate of growth of Gross Domestic Product (GDP), the sum of all the nation's output of goods and services. The CBO projects 3.0 percent, on average, for the next decade; President Clinton's OMB projected 3.1 percent; the consensus of private Blue Chip economists is 3.3 percent.

Whatever the projections, already the market for U.S. government securities "is fast disappearing," says Francis X. Cavanaugh, who, as a federal official, managed the federal debt at the Treasury Department. The Treasury has discontinued regular auctions of 52-week bills and 3-year, 4-year, and 7-year notes. "It is expected to eliminate the 30-year bond as well," he says. "That leaves only the 13-week and 26-week bills and the 5-year and 10-year notes." But the 10-year is slated for extinction next year.

This is an unprecedented condition in government finance, and, while it sounds perfectly wonderful, it's not. Paying off the debt has many negative consequences in addition to government ownership of corporate stocks. As Alexander Hamilton, the first treasury secretary, said, "The national debt, if it is not excessive, can be a national blessing."

One big problem is that Treasury debt provides investors—and the world financial system—with stability and consistency, nice things to have in a time of volatile markets. Treasuries are used by small investors, charities, and other institutions that want a secure flow of income and by financial institutions fashioning derivatives and other instruments that spread risk and modulate it. Too bad for them; they'll have to go elsewhere after 2006—but, of course, there is no elsewhere; there's nothing that comes close to the security of a Treasury security.

Another problem is that Treasuries are popular with foreign investors and governments. They are one of the major reasons that the U.S. dollar is the world's reserve currency—a status that keeps the dollar strong and interest rates low. (It also means a multi-billion-dollar windfall in "seigniorage," as foreigners give us interest-free loans of their currency in order to hold ours.)

A third difficulty is already starting to show up. As the Treasury starts eliminating certain securities, the value of the remaining securities rises—which, in bond terms, means that their interest rates fall. As a result, distortions in rates along the Treasury yield curve have blossomed. For example, interest rates have plummeted on the 30-year bond, which will soon become history.

So what? Treasury securities are benchmarks for other kinds of lending. Many adjustable mortgages, for example, are linked to the why. They want to prevent a tax cut so that they can eventually use the $3 trillion in uncommitted funds either for new spending or for government investing in stocks.

What about the argument, heard from both parties, that if we don't retire bonds now, then we will irresponsibly be saddling our children and grandchildren with debt? Actually, the opposite is true. As time has passed, new generations have always had higher incomes, so they are better able to pay off the debt. Indeed, retiring the debt is more apt to harm future generations. It would be better for our children, says Allan Meltzer, also of AEI, "if we reduced tax rates now, encouraged investment now, so that we would have a larger capital stock and higher incomes. They, too, would have a larger capital stock that would produce income that could be used to retire the debt that they inherit from us along with the capital stock."

In other words, the greatest gift we can give future Americans is a booming economy—with abundant physical and intellectual capital on which to draw. The real question is how to get there.

Clearly, the answer is not by repaying the debt, a process that is already causing serious disruptions in the capital markets and that confers no conceivable benefits on the United States. Instead, the answer is to stop the tidal wave of cash flowing into the Treasury by allowing Americans to keep more of what they earn.

This year, federal taxes will reach 20.7 percent of GDP. Only once, in 1944, has Washington taken a higher proportion of national income—and only twice (the other year was 1945) has it taken more than 20 percent. But, according to CBO, taxes will exceed 20 percent of GDP in every year through 2011. Currently, the Treasury is absorbing one-sixth more in revenues than it needs to operate the government. That's an overcharge that will mount with the years—reaching an incredible one-third by 2010.

If we end the overcharge through a tax cut, some of the income that doesn't go to Washington will be consumed, giving an immediate boost to an economy that has been sagging. The rest will be invested, adding to the capital stock and increasing productivity and incomes for future generations. That's a far more sensible—and far less risky—approach than shutting down the Treasury market.

By James K. Glassman

Testimony Prepared for the Subcommittee on

Domestic Monetary Policy, Technology and Economic Growth

of the

U.S. House of Representatives

Committee on Financial Services

March 29, 2001

By

Martin Neil Baily

The author is a Senior Fellow at the Institute for International Economics in Washington DC. He was previously the Chairman of the Council of Economic Advisers and a member of President Clinton's cabinet (August 1999 to January 2001). He has also served as a Member of the Council. The views expressed here are those of the author and should not be ascribed to the trustees, or other staff members of the Institute for International Economics.

Summary

After experiencing one of the best and longest expansions ever in US economic history, the economy slowed in the third quarter of 2000. While policymakers were looking for and wanting a moderation in growth, the slowdown has been sharper than expected in recent months. While areas of economic weakness are evident, the strong fundamentals of low unemployment and inflation remain in place, and the chances are good that an outright recession will be avoided. Slow growth is likely this year but normal growth should resume after that, even if there were no tax stimulus package.

Monetary policy is the first and most effective way to avoid or to combat recession and the Fed has acted quickly to lower rates. It may need to take further steps to lower rates if the weakness continues. Monetary policy is the best policy to get us back on track.

Past history suggests that manipulating taxes in order to stabilize the economy is rarely effective and can be harmful. More importantly, we must keep in place the policies that contributed to the outstanding economic performance of recent years. 1. The policy of fiscal discipline—shifting from deficits to surpluses--paid off handsomely and must be sustained. This requires that the future path of discretionary spending must be forecast realistically, and the uncertainty in revenue projections recognized. 2. The budget surpluses that fiscal discipline have generated provide a unique opportunity to meet the challenges of Social Security and Medicare reform. 3. The US must move over time to reduce its trade and current account deficits. To do this we must, as a nation, reduce the gap between what we spend and what we produce. Cutting taxes moves us in the wrong direction and makes it harder to solve the trade gap.

Rapid economic growth over the long run requires that we invest in the future. This helps productivity, which then increases wages and family incomes. And it also helps the Federal budget, thereby creating a virtuous cycle. Fiscal discipline is a way of increasing the amount of capital available to the economy and supporting future growth.

A tax stimulus package is likely to have only a modest effect on the current short-term weakness. Any tax cut should be moderate in size; it should be designed to come into effect now. And it should be targeted to low and moderate income families that need help in a softer economy.

But whatever the pros and cons of a moderate tax cut or rebate to stimulate the economy, a very large, long term tax cut that phases in gradually over the coming years is the wrong approach to deal with a temporary economic slowdown.

The latest jump in consumer confidence is welcome, but some families are still nervous. An important reason is that they see the consequences of job loss. Bills cannot be paid and health insurance may evaporate. This is an appropriate time to review Federal programs, like unemployment insurance, that help those who may be hurt by layoffs. Making sure that job losers and their families can avoid financial disaster and maintain access to health care would further increase consumer confidence.

The Current Economic Situation

Real GDP grew at a rate close to 6 percent for the four quarters from mid 1999 to mid 2000. With a labor market that was already tight, this pace of expansion was not sustainable over the long term. The economy had to slow down. There was so much good economic news that stock market investors got carried away. Stock indexes reached levels that were not justified by realistic estimates of future earnings. Some adjustment in the markets was inevitable.

There is no question the slowdown is painful, that many companies, particularly in manufacturing and high-tech, are experiencing wrenching adjustments. Some workers are being laid off. New jobs are scarcer. But Congress should avoid making bad policy in an over-reaction to what is likely to be a short run problem.

The fundamentals of the economy are very strong. The unemployment rate in February was 4.2 percent and the economy was still adding jobs. This unemployment rate is far lower than at any time in the 1970s and 80s. The Dow-Jones index has fallen, but this follows a period of extraordinary increases. Ups and downs in the economy and in markets are inevitable. The miracle is how long the expansion has lasted and how strong it has been, with broadly-rising wages and incomes. It is amazing how much wealth has been created. And the chances are good that the current expansion will continue, albeit at a slower pace than before.

The first line of defense against recession is monetary policy. The evidence of recent history is that the Fed has the power to act quickly and forcefully to rein in an economy that is going too fast, as it did in 1999 and 2000, or to stimulate an economy that is going too slow. And the Fed has indeed acted quickly in response to the changing economic circumstances. But monetary policy takes time to work. It took a while for rising rates to cool off the economy and it will take a while for lower rates to have their full impact. But the economy does have its own recuperative powers. Once excess inventories have been worked off, production turns up again. And there are automatic stabilizers on the fiscal side. Laid off workers collect unemployment insurance. A slowing economy will automatically increase spending for support programs and decrease tax revenues. Budget surpluses at the Federal, State and Local levels will be lower than had been projected, even without any action from policymakers.

The Limits of Discretionary Fiscal Policy

The use of fiscal policy changes to stabilize the economy is based on a simple and valid principle. When consumers are not spending and there is weakness in aggregate demand, tax cuts can encourage spending by increasing after-tax incomes.

Three factors weaken this simple argument for discretionary fiscal policy. First, consumers will likely spend only a part of any tax windfall, particularly if they are worried about future economic conditions. So each dollar of tax cut will translate into only a fraction of a dollar of extra spending. Second, tax cut legislation has to be enacted and the impact has to be felt in people's after-tax incomes. This all takes time and the effect of the tax cut may happen after the economy has already started to recover and the tax cut is no longer needed. Third, a large tax cut means that the Federal budget will run smaller surpluses or possibly deficits. There will be less revenue to pay down the debt, so that long-term interest rates will be higher, and this will discourage investment spending.

The effectiveness of a tax cut would be enhanced if it gives help to low and moderate income families. Such families need all the after-tax income they can get to provide for essentials and are likely to spend most of any tax rebate. A small tax cut would not undermine fiscal discipline.

The Benefits of Fiscal Discipline and Investment

The U.S. economy has performed extraordinarily well, sustaining strong accelerating growth through the first half of 2000, with low inflation, unemployment close to 4 percent, rising household incomes and declining poverty. This stellar performance was achieved with steady reductions in the budget deficit, followed by strong budget surpluses.

The keys to strong economic performance over the long run lie in rapid innovation, a high level of investment, and a skilled workforce. One sign that the economy performed well in these areas is the rapid rate of productivity growth. From the cyclical peak in 1989 through the third quarter of 2000 output per hour in the non farm business grew at 2.3 percent a year, far faster than the anemic rate of 1.4 percent a year that was the prior trend. Almost all of this improvement took place in the second half of the 90s. From 1995 through 2000 productivity increased by about 3 percent a year. Other signs of dynamism during this period abound. There was a surge in R&D and in the number of patents granted. New firms proliferated.

Economic policy must create an environment in which these conditions can continue. Fiscal discipline alone did not cause this exciting change, but it helped substantially. It kept interest rates low, encouraging investment, contributing to a strong stock market and allowing millions of Americans to afford houses, cars and other durable goods. Moreover, those who argue today that large tax cuts are needed in order to provide incentives for growth must confront the fact that innovation and growth have been spectacular for a number of years, with rising wages and family incomes. To demand a major shift in economic policy because of a few slow quarters makes no sense.

The size of Federal discretionary spending relative to the size of the economy was substantially reduced in the 1990s and it will be hard to go much further. (Discretionary outlays fell from 8.6 percent of GDP in FY 1992 to 6.3 percent in FY 2000). There is broad agreement that America needs a strong defense in a dangerous world. It would be a mistake to cut support for research, education, child-care assistance, and other needed programs in order to finance a large tax cut. Budget projections must be based on a realistic view of what spending is likely to be.

A strong economy demands investment in the future. Fiscal discipline encourages private sector investment. The Federal government makes health, technology and education investments that support American families and support the private sector.

The Challenge for Social Security and Medicare

Projections indicate that the population aged 65 and over will rise from its current share of about 12 1/2 percent of the total population to nearly 21 percent by 2040. Currently the Social Security and Medicare trust funds are running surpluses. But as the proportion of elderly in the population rises, this situation will reverse and the trust funds will run deficits and become depleted, in the absence of any reforms. Medicare also faces the pressures coming from projected increases in health care costs. The long run fiscal position of the Federal government is not nearly as rosy as the short run position.

For Social Security in particular, the trust fund is expected to run out by 2038. Current budget surpluses provide the opportunity to carry out long run reform. The problem of Social Security funding could be solved once-and-for-all by shifting from the current pay-as-you-go system to a fully-funded system. Today, the benefits paid to retirees come from the Social Security taxes paid by current workers. In a fully-funded system, the moneys paid in by current workers would be used to purchase bonds or stocks. On retirement, participants would receive an annuity income paid for by the wealth they had built up in the system. It is very hard to get from where we are now to this new situation because of the transition problem. The current Social Security surplus will be needed to pay today's workers as they retire. But part or all of the budget surpluses over and above the Social Security surplus could be used to ease the transition problem and allow us to start the shift towards a fully-funded system.

Dealing with the Current Account Deficit

The US is now borrowing $500 billion a year to finance its trade and current account deficit with the rest of the world. This is about 5 percent of GDP and we have already accumulated $2 trillion of net indebtedness to the world. Americans benefit from the ability to buy more goods overseas than it sells and attract foreign capital to pay for it. But all of that borrowing will have to be serviced over time. The huge trade and current account deficits are not sustainable in the long run. We cannot continue to borrow at this rate indefinitely.

Running an international or current account deficit means that, as a nation, we are spending more than we are producing. American families spend most of the income they receive, setting aside very few cents of each dollar in the form of saving. Total saving out of National Income does not finance the level of investment businesses see as profitable, and so the gap is filled by foreign borrowing.

The strong US economy has helped to offset this low saving out of income. Americans are much wealthier than they were in 1990 because of the rise in the stock market and in housing values. But it is time for us to accumulate wealth the old-fashioned way, by saving more. There are limits to the flow of capital that can be provided by other countries. US interest rates will rise as those limits are reached and abrupt changes in the dollar are possible, just as happened in the 1980s.

Historically, the Federal government has run budget deficits that were a reduction in national saving. But in the past few years the budget surpluses have contributed positively to national saving. It is vital to continue that contribution and not undermine the needed increase in national saving.

Doing More: Decreasing Uncertainty

One reason that some Americans are nervous is that losing a job can be such a traumatic event. The long period of good times has led many to stretch themselves with credit card debt or big mortgage payments. Being out of work could break the bank very quickly. And tax cuts do not do much to help those who do not have jobs. Losing a job often means losing health insurance coverage.

The current slowdown is a good time to look at programs that reduce the economic uncertainty faced by American families. Is the current unemployment compensation system adequate? Is there adequate help in dealing with credit cards or other debt problems? Will families be punished by creditors following a spell of unemployment? How do we make sure that job losers can still take their children to the doctor? Do we provide enough assistance to help people who must find new jobs? Why don't we do something to help the 40 million Americans without health insurance? That would sure help consumer confidence.

Conclusion

The amazingly strong economic performance of the US economy in recent years, with strong accelerating growth through mid 2000, should provide a guide to future policy choices. Having found policies that have worked so well, let's stick with them. The current slowdown is cyclical not structural and we need to stay on the long-run course.

Monetary policy is the strongest and most effective medicine to fight off a recession or restore growth if a recession should happen. Let's give this medicine a chance to work.

It is not clear that any fiscal stimulus package is needed or would be very effective. But if one is passed, it should be immediate, modest in size and geared to help low and moderate income families.

Preserving fiscal discipline increases national saving, encourages investment and productivity growth and reduces our international deficit. And these, in turn, increase wages and family incomes.

Policies to preserve fiscal discipline must be based on a realistic assessment of spending and must allow for the great uncertainty of revenue estimates.

Testimony of Lawrence Kudlow

March 29, 2001

It is a pleasure to appear before the Subcommittee on Domestic Monetary Policy, Technology, and Economic Growth.

Let me be as brief as possible. Attached to my testimony is a series of charts that illustrate some of today's economic issues.

We are in the midst of the first significant economic and stock market slump in ten years. The stock market decline began roughly one year ago. The economic downturn first appeared in last year's third quarter. Market indexes have entered bear territory, defined as a 20% drop registered over a period of at least six months. As for the economy, I estimate the probability of recession to be roughly 50%.

In terms of identifying the causes of the current economic problem, I believe excessively tight Federal Reserve policies deserve special mention. Our nation's central bank continued to tighten policy last year despite the emergence of an inverted Treasury yield curve, a classic recession signal, and declining gold and commodity prices. After expanding the monetary base by roughly 16% in 1999, itself an overly accommodative policy, the Fed proceeded to deflate this measure of high-powered liquidity at a 2½% rate in 2000. It is one of the largest swings from stimulus to restraint in history.

Repeated energy shocks in 1999 and 2000 also play a role in the downturn. The upward price swing in various energy commodities caused a roughly $65 billion transfer of incomes from U.S. consumers to OPEC producers. Additionally, higher prices for oil, home heating fuel, natural gas, auto gasoline fuel, electricity and other energy goods caused roughly $100 billion of consumer spending to be diverted from non-energy purchases to pay these energy bills. As a rough approximation, it could be argued that the energy shock lowered gross domestic product by as much as two percentage points cumulatively since early 1999.

Another economic problem has been the rising incidence of what is called real income tax bracket creep. I estimate this to be in the neighborhood of $125 billion over the past four quarters. Successful workers have been pushed into higher tax brackets as real incomes have increased. So within the tax system, millions of people have experienced higher tax rates.

All this said, the question is what to do about it? Obviously, Federal Reserve policies have belatedly turned more stimulative. This is a good thing, though the monetary authority has much more work to do. I believe its overnight policy rate should be lowered to 4% as soon as possible from the current 5% level. In all likelihood a 3½% fed funds rate will become appropriate before the easing cycle is complete. Monetary base growth has accelerated slightly to 3½%. I believe the year-to-year change in this key measure of high-powered bank reserves should range between 6% and 10%.

Hopefully, U.S. energy policies will tilt substantially more in the direction of producing oil and gas in the period ahead. Our information technology economy requires substantial additions to the stock of electricity in order to fuel the wired economy. Hence, greater production of natural gas will be necessary. Also, renewed interest in nuclear energy is appropriate. A tougher U.S. diplomatic stance with respect to OPEC production decisions also seems appropriate. Free markets, not commodity cartels, should be permitted to set world prices.

Finally, tax reduction should be called on to play a major economic recovery role. There is much debate on this whole issue right now. Let me weigh in.

I believe the best thing we can do to restore the stock market and economic growth is to provide shock therapy in the form of immediate reduction for personal tax-rates across-the-board and the capital gains tax rate. As quickly as the legislative process permits, the best thing lawmakers can do this year is to lower personal and capital gains tax-rates retroactively to January 1, 2001. Later on, pension tax reforms should move forward unlimited and universal IRAs and 401(k)s. Estate tax reform and corporate tax reform are also pro-recovery measures. All these reforms will raise the economy's long-run potential to grow.

The biggest problem facing the economy is the loss of capital and the deflation of wealth that has occurred over the past year. The Federal Reserve Board has, ironically in view of their culpability, reported a $2 trillion family wealth decline for 2000. Various market analysts estimate the decline of stock market wealth to range between $4 trillion and $5 trillion. Along with the shrinking economic growth rate, these massive wealth losses have substantially increased investment risk premiums and capital cost. Risk-taking has sunk to low ebb.

Meanwhile, recent economic statistics show that the supply-side of the economy is sagging badly. Non-defense capital goods orders have fallen in four of the past five months. Capital goods shipments have dropped 14% at an annual rate over the past three months. This includes technology shipments, where orders for industrial machinery goods and electrical machinery have fallen by, respectively, 7% and 13.9%, both at annual rates. Substantial inventory overhangs exist in virtually all industrial and technology sectors. Meanwhile, the index of industrial production has declined five consecutive months. This important coincident indicator is flashing recession. So is the index of leading indicators, which are now declining on a twelve-month rate of change basis.

In light of these data, proposals for a one-time consumer tax rebate make no sense at all. Right now consumption is not the biggest economic problem. In fact, inflation-adjusted personal spending increased at a nearly 3% annual rate in the fourth quarter, and looks to be rising at roughly 3% in this year's first quarter.

But domestic business investment declined by nearly 4% in the fourth quarter of 2000, and, judging by the disappointing factory numbers, will decline again the first quarter, perhaps by as much as 5% annually. Though some economists disagree, I believe that consumer spending and personal income is ultimately generated by investment and production increases. Classical economists have long argued that we invest and produce in order to consume. Production generates jobs, jobs create income, and income provides the resources for consumer spending.

If, on the other hand, the decline of investment and production is not halted, then the downturn will produce significant unemployment. This will undermine personal incomes and consumption. So it is my view that one-time consumer tax rebates, which have no permanent economic impact, nor any behavioral impact, is putting the cart before the horse. Really, a waste of money.

Instead, current conditions warrant tax relief measures that will stimulate investment and production. Incentive rewards need to be raised, and after-tax capital costs must be reduced. The surest way to achieve this goal is a permanent reduction in the marginal tax-rates on personal income and capital gains. Bear in mind that upper bracket income earners are the primary source of capital for our economy. Also, nearly one-fifth of upper bracket tax filings are made by small operator-owned businesses, Sub-Chapter S companies, limited liability partnerships and so forth.

Therefore, reduced personal tax-rates will lower capital cost hurdle rates for investment and will increase after-tax rewards for additional investment risk-taking. The economy has suffered a major deflation of capital and wealth. By relieving tax burdens on capital and wealth, we can begin to resurrect the supply-side sector of the economy. Dropping the tax-rate on capital gains should be a major component of this recovery plan. Capital gains relief, as you know, is a self-funding tax-cut that will actually stimulate a surplus of future revenues.

The compression of equity asset values over the past year has unleashed numerous adverse consequences to technology innovation and new business formation. Price-earnings multiples in the S&P 500 stock index have shrunk from 33 to 22. At 33 times earnings, the earnings yield on S&P stocks was 3% a year ago. However, at 22 times earnings today, the earnings yield has jumped to 4.5%. This means that equity financing has become 50% more expensive, a considerable deterrent to business and capital expansion. Entrepreneurs right now are starved for credit.

As a result, equity funding for initial public offerings or other forms of venture capital is now virtually non-existent. Entrepreneurs could of course apply to commercial banks and other lenders, but lending standards have tightened substantially in recent months, virtually foreclosing this credit source.

In order to revive sinking investor spirits, I recommend the shock therapy of immediate tax-rate reduction, made retroactive to the beginning of this year, for personal tax-rates and capital gains. This would provide a positive jolt to stock market sentiment, a positive jolt to venture capital financings, and a positive jolt to risk-taking in general.

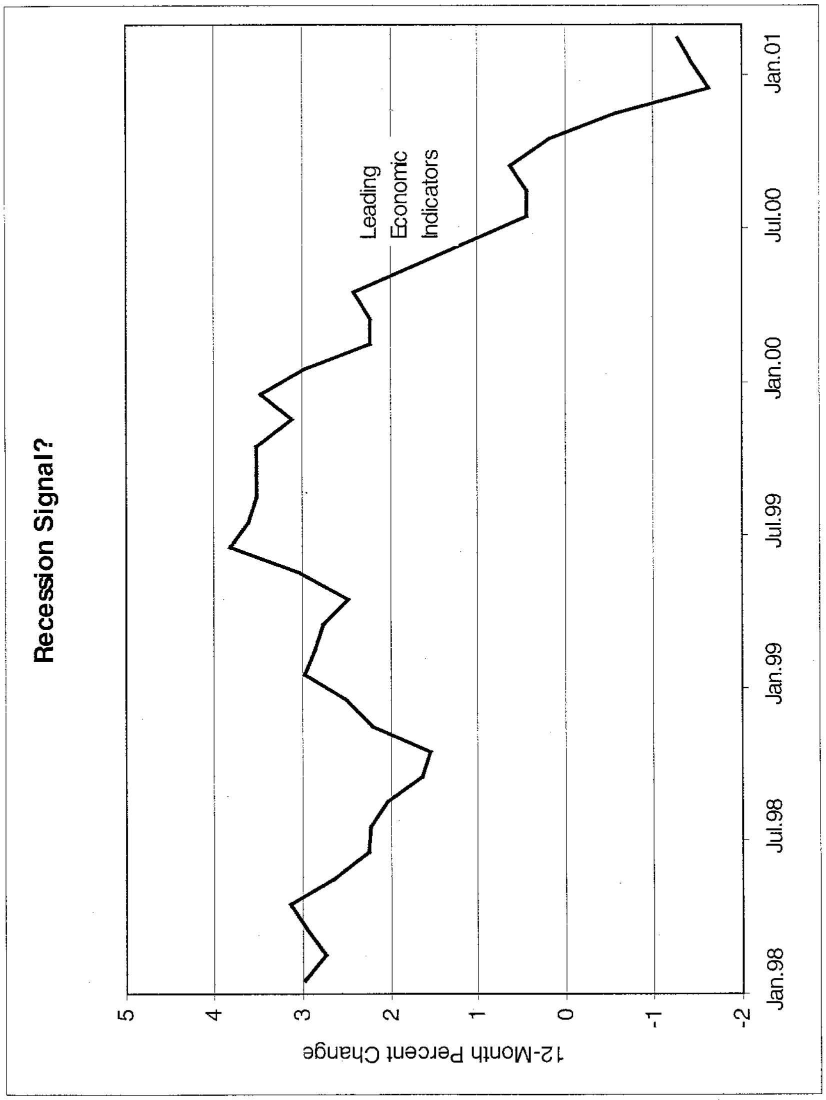
In short, rapid and accelerated tax-rate relief on incomes and capital would provide a positive jolt to the entrepreneurial spirits of the economy.

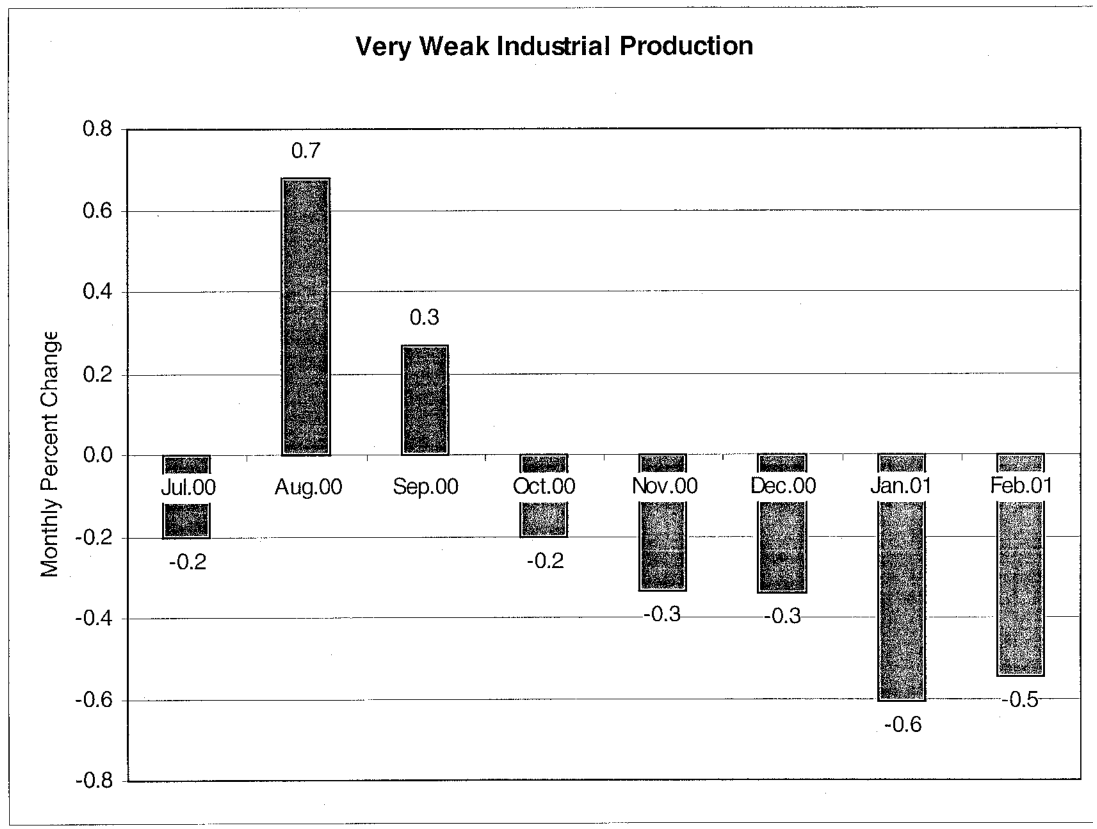
This is what it will take to move the U.S. economy back toward the 5% growth path that we experienced before the Federal Reserve embarked on its unnecessary policy errors that eviscerated the stock market and de-funded the economy.

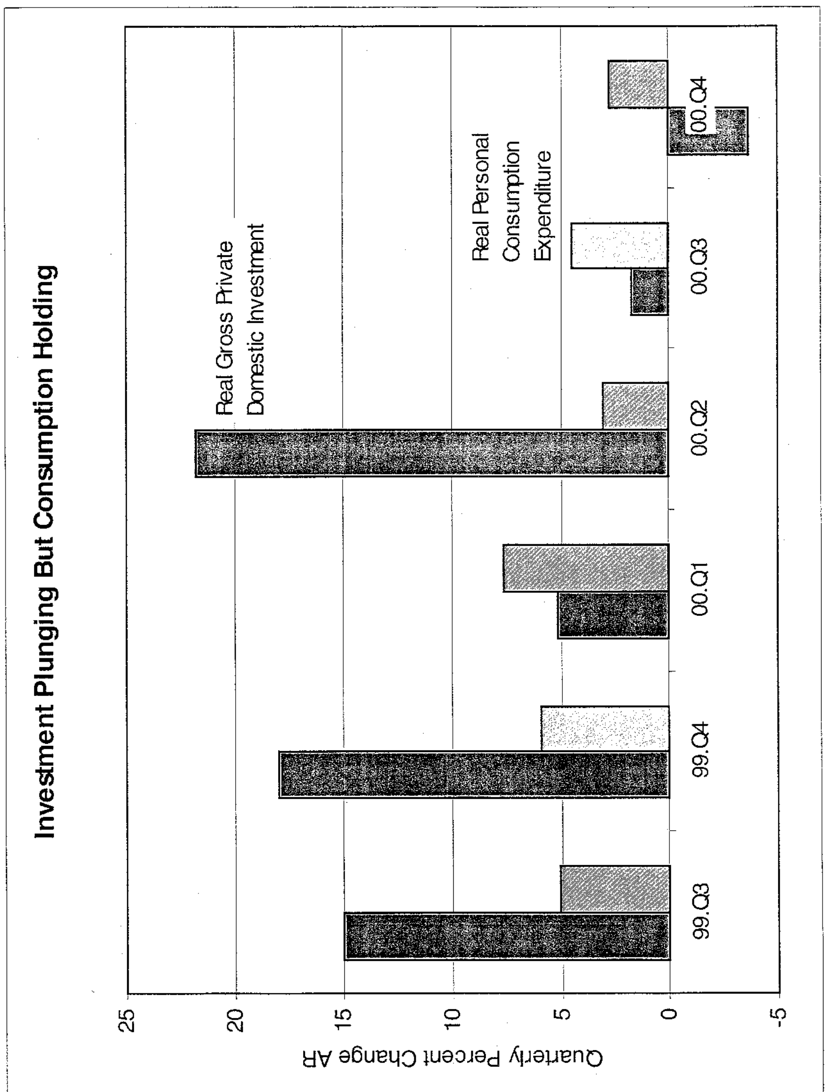
Technology innovation is the backbone of our modern economy. Tremendous contributions to technology investment have increased productivity gains and economic returns everywhere. But innovation and investment require new incentives if we are to overcome the deleterious effects of the stock market plunge and the economic downturn. Reducing tax-rates on personal income and capital gains will raise the return and lower the after-tax cost of capital, thereby at least partially offsetting the significant capital cost increases and newly-imposed investment risk premiums that the economy has suffered as a consequence of the stock market plunge.

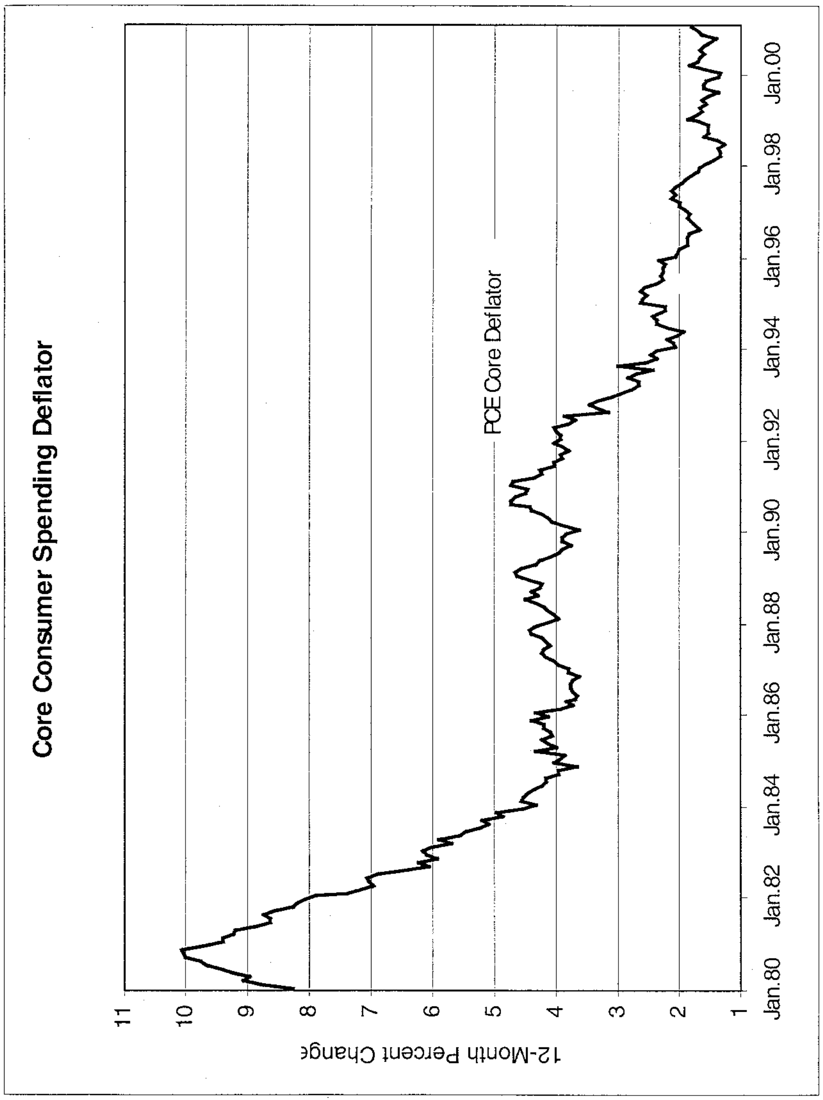
Entrepreneurs and investors will welcome such policies. So will ordinary working families. Over 100 million Americans today own stocks. Over 130 million Americans today are employed in business. Everyone will benefit from permanent reductions in the tax-rates on income and capital.

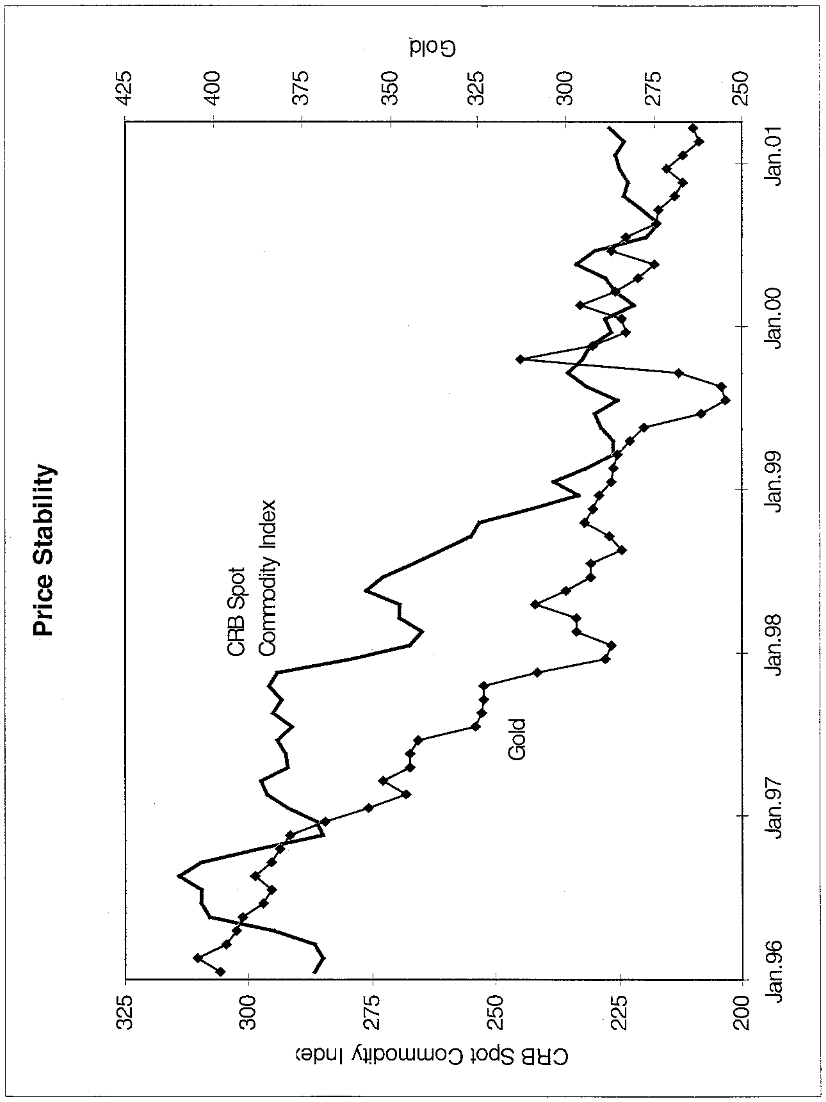
Thank you for giving me an opportunity to provide this testimony.

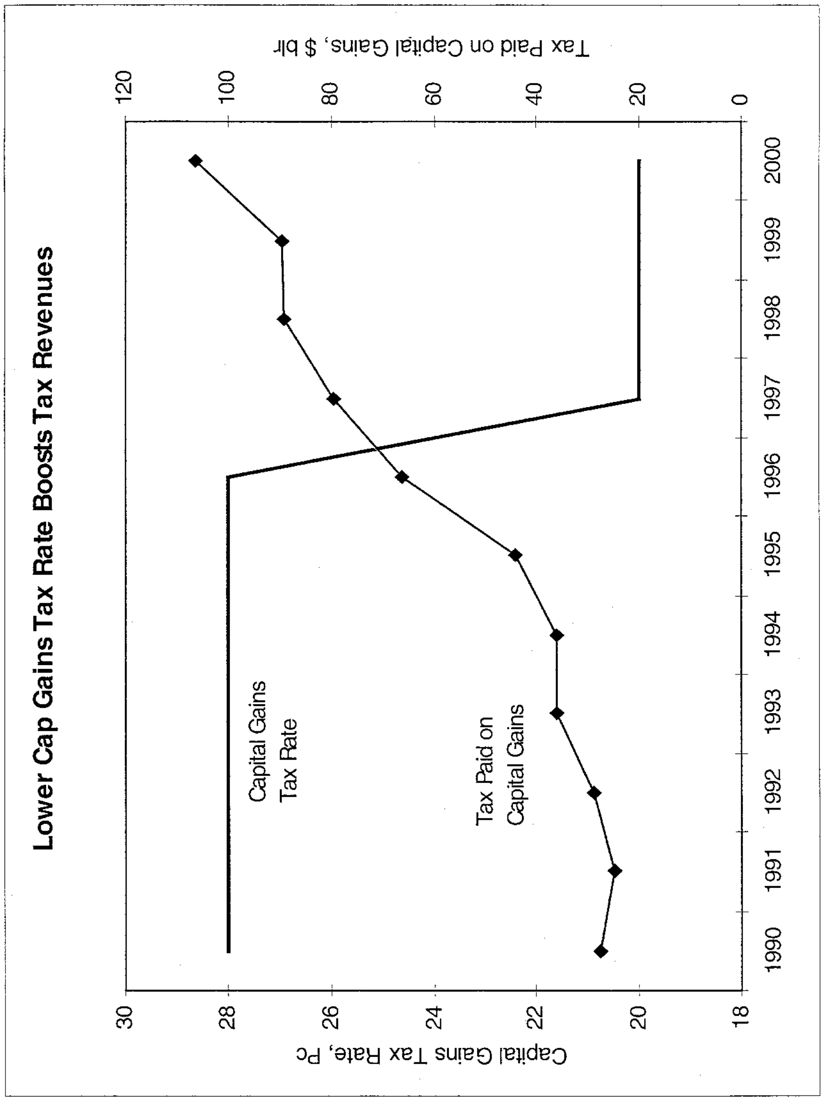

Recession Signal?
12-Month Percent Change
5
4
3
2
1
0
-1
-2
Jan.98
Jul.98
Jan.99
Jul.99
Jan.00
Jul.00
Jan.01
Leading
Economic
Indicators

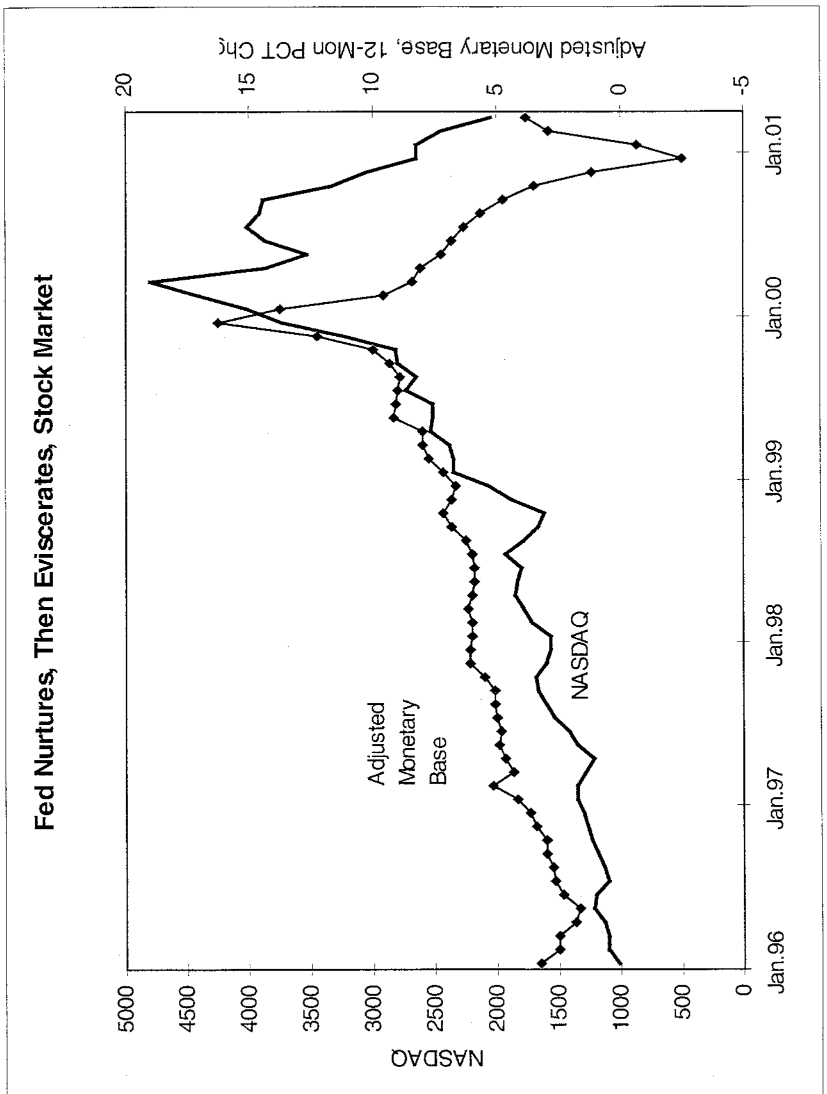

Very Weak Industrial Production
Monthly Percent Change
0.8
0.6
0.4
0.2
0.0
-0.2
-0.4
-0.6
-0.8
Jul.00
Aug.00
Sep.00
Oct.00
Nov.00
Dec.00
Jan.01
Feb.01
-0.2
0.7
0.3
-0.2
-0.3
-0.3
-0.6
-0.5

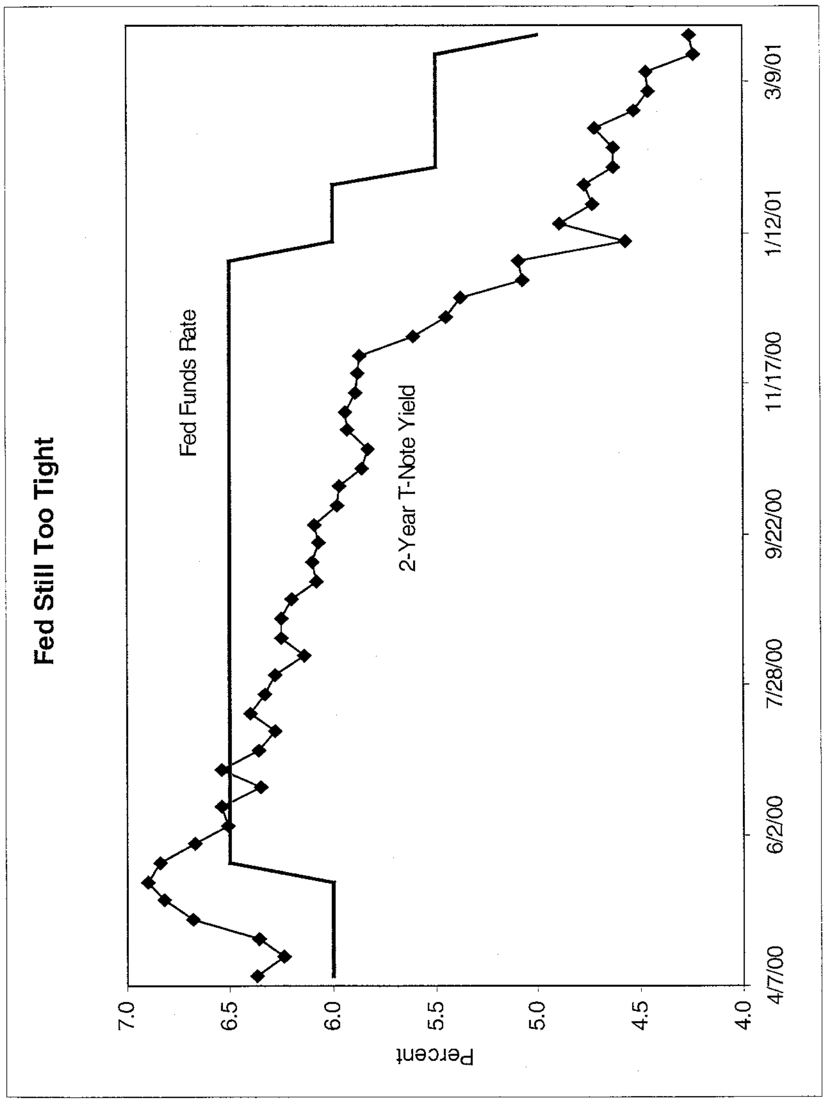

Investment Plunging But Consumption Holding
Real Gross Private
Domestic Investment
Real Personal
Consumption
Expenditure
Quarterly Percent Change AR
25
20
15
10
5
0
-5
99.Q3
99.Q4
00.Q1
00.Q2
00.Q3
00.Q4

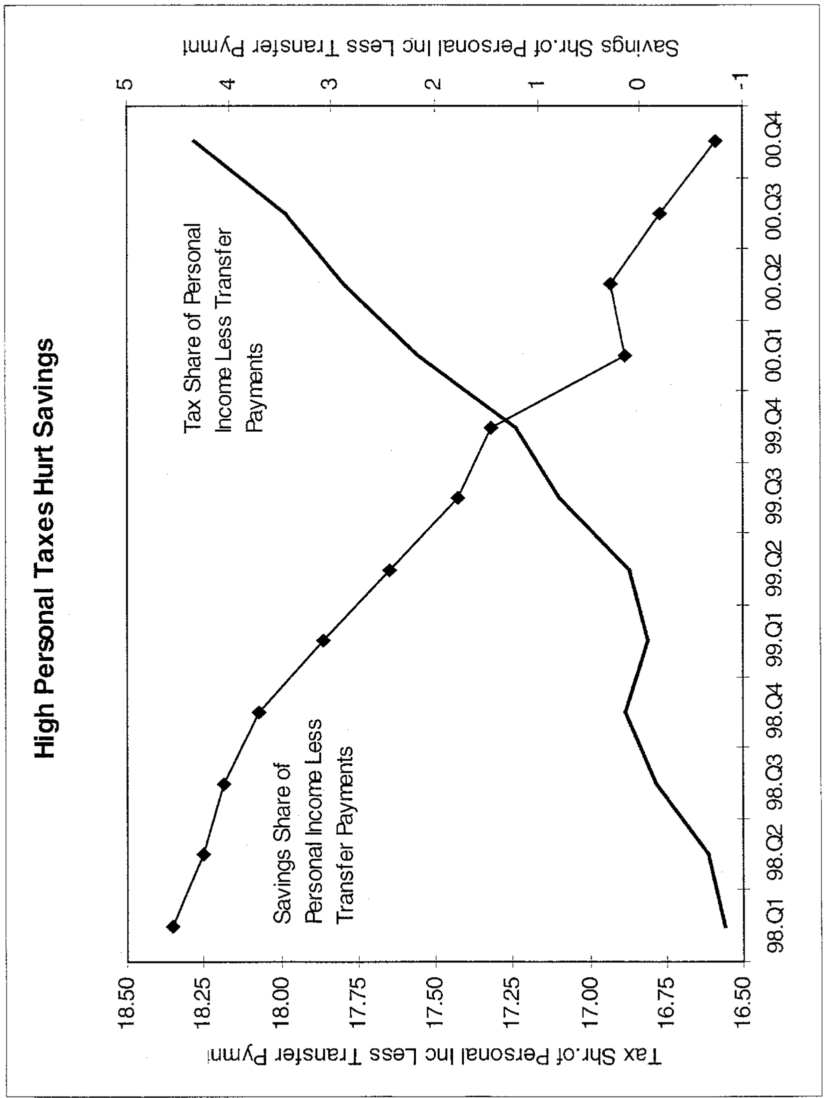

Core Consumer Spending Deflator
12-Month Percent Change
11
10
9
8
7
6
5
4
3
2
1
Jan.80
Jan.82
Jan.84
Jan.86
Jan.88
Jan.90
Jan.92
Jan.94
Jan.96
Jan.98
Jan.00
PCE Core Deflator

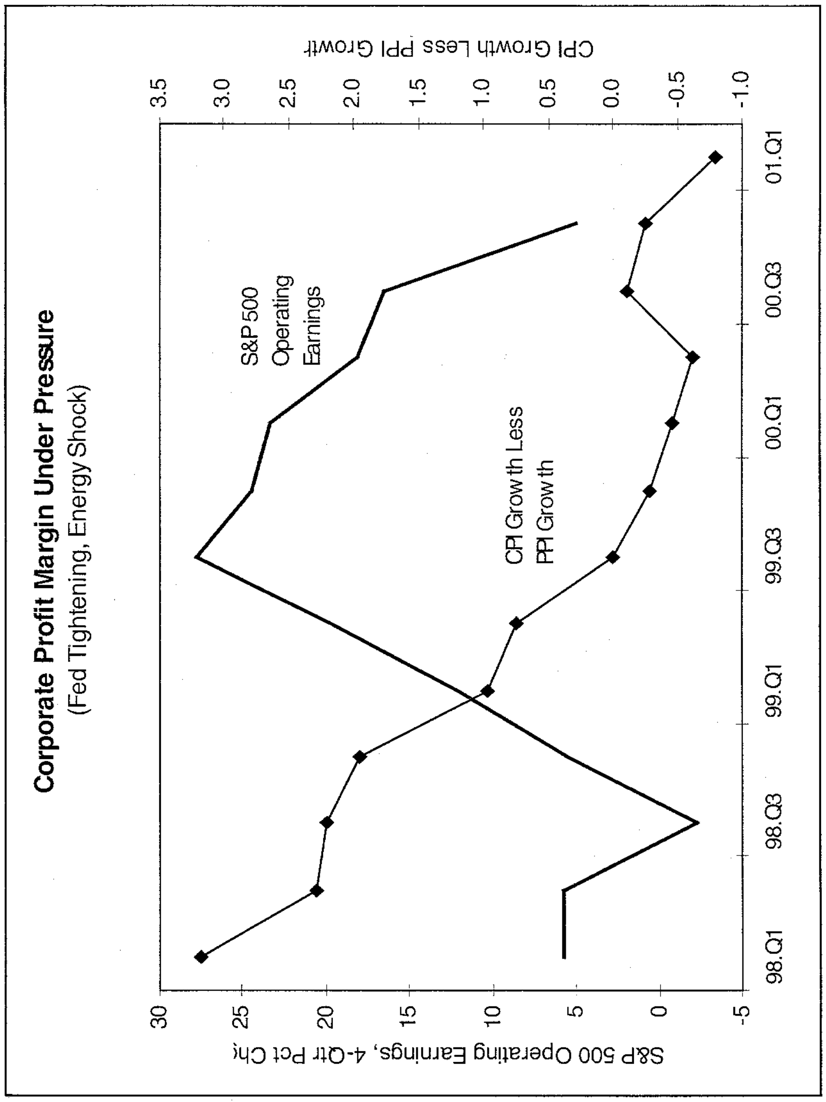

Price Stability
CRB Spot Commodity Index
Gold
CRB Spot Commodity Index
325
300
275
250
225
200
Gold
425
400
375
350
325
300
275
250
Jan.96
Jan.97
Jan.98
Jan.99
Jan.00
Jan.01

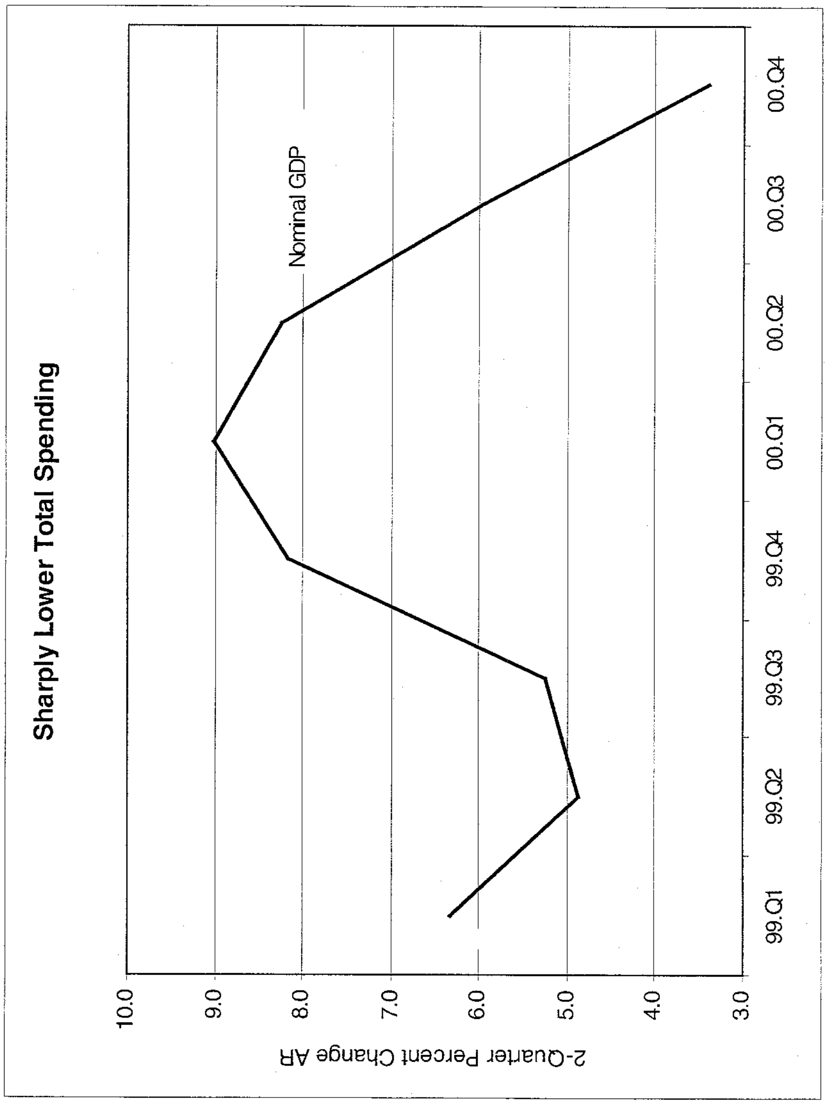

Lower Cap Gains Tax Rate Boosts Tax Revenues
Capital Gains Tax Rate, Pc
Tax Paid on Capital Gains, $ bln
Capital Gains
Tax Rate
Tax Paid on
Capital Gains
30
28
26
24
22
20
18
120
100
80
60
40
20
0
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000


Fed Nurtures, Then Eviscerates, Stock Market
NASDAQ
Adjusted Monetary Base, 12-Mon PCT Ch
5000
4500
4000
3500
3000
2500
2000
1500
1000
500
0
20
15
10
5
0
-5
Jan.96
Jan.97
Jan.98
Jan.99
Jan.00
Jan.01
Adjusted Monetary Base
NASDAQ


Fed Still Too Tight
Fed Funds Rate
2-Year T-Note Yield
Percent
7.0
6.5
6.0
5.5
5.0
4.5
4.0
4/7/00
6/2/00
7/28/00
9/22/00
11/17/00
1/12/01
3/9/01


High Personal Taxes Hurt Savings
Tax Share of Personal Income Less Transfer Payments
Savings Share of Personal Income Less Transfer Payments
Tax Shr.of Personal Inc Less Transfer Pymnt
Savings Shr.of Personal Inc Less Transfer Pymnt
18.50
18.25
18.00
17.75
17.50
17.25
17.00
16.75
16.50
5
4
3
2
1
0
-1
98.Q1
98.Q2
98.Q3
98.Q4
99.Q1
99.Q2
99.Q3
99.Q4
00.Q1
00.Q2
00.Q3
00.Q4


Corporate Profit Margin Under Pressure
(Fed Tightening, Energy Shock)
S&P 500 Operating Earnings
CPI Growth Less PPI Growth
S&P 500 Operating Earnings, 4-Qtr Pct Ch
CPI Growth Less PPI Growth
30
25
20
15
10
5
0
-5
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
98.Q1
98.Q3
99.Q1
99.Q3
00.Q1
00.Q3
01.Q1


Sharply Lower Total Spending
2-Quarter Percent Change AR
10.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
Nominal GDP
99.Q1
99.Q2
99.Q3
99.Q4
00.Q1
00.Q2
00.Q3
00.Q4