Testimony of

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Chairman Graves, Ranking Member Velázquez and members of the Committee, I am delighted to be invited to testify before you on the state of the overall economy and the economic outlook. I will touch briefly on only a few of the aspects of our economy and our economic challenges in my remarks but look forward to your questions on a wide-range of issues.

Introduction and Overview

I characterize the U.S. economy as being in a "sideways slide" and this is likely to continue, unless we experience a major shock to the downside or have an important resolution of uncertainty. Over the last year, the unemployment rate has changed little, hovering around 8 percent. The job growth averaged about 180,000 per month in 2012. That is just about the number that offsets the gradual increase in the population and the labor force, which explains why the unemployment rate has stayed stubbornly high despite this job growth.

In 2012, GDP grew by 2.2 percent and has been growing at roughly a 2 percent pace since the recovery began in mid-2009. The GDP estimate for the fourth quarter of 2012 implied a slight contraction in growth. I do not, however, think this portends a "double-dip" because the poor overall economic performance last quarter was likely due to a number of temporary factors including Hurricane Sandy and a sharp contraction in federal government spending following a sharp increase in the previous quarter.

I believe that we are likely to see growth in the low to mid 2s going forward, continuing our "sideways slide," and thus unlikely to achieve a robust bounce-back that would rapidly bring down the unemployment rate. Most private sector and official forecasts see U.S. GDP growth in a range from the mid 1s to the mid 2s for 2013 and have the unemployment rate declining painfully slowly.

The rate of inflation continues to be subdued. Since mid-2009, inflation as measured by the personal consumption expenditures (PCE) index has averaged roughly 2 percent per year. It was 1.7 percent for 2012. Certainly, swings in energy, food, and other commodity prices have important short-term impacts on the prices that consumer pay, but the overall rate of inflation has been moderate and I believe is likely to stay that way over the near to intermediate term. Surveys of consumers, surveys of professional forecasts, and data from markets all imply that inflation-expectations are well-anchored. None of these measures suggest expectations of high inflation but, of course, it is important to be alert to changes in inflation pressures and inflation expectations as the economic situation evolves.

I would like to see the US achieve a more robust non-inflationary recovery and believe that we can. I will next provide more details and background on current economic conditions and some factors that are holding us back from a more robust recovery and then briefly touch on ways in which policy actions and the resolution of policy uncertainty might strengthen economic growth.

Economic Conditions and Outlook

Consumption continues at a steady pace. Real personal consumption expenditures grew 2.2 percent in the fourth quarter of 2013. Real disposable personal income increased 6.8 percent last quarter, but this sharp rise reflects some one-time factors. In particular, many firms accelerated dividends or paid special dividends in anticipation of increases in the personal tax rate. The personal saving rate, calculated as a percentage of disposable personal income, was 4.7 percent, roughly in line with the average savings rate since the crisis.

The housing market has an important impact on consumption behavior. A key headwind that explains the relatively slow pace of recovery is housing. Typically, housing rebounds relatively quickly and robustly after a recession, and this in turn helps to increase consumer wealth and confidence. During the last five years, housing prices across the US have fallen by one third and the residential construction sector shrank considerably.

The low interest rate policy of the Federal Reserve, coupled with the purchases of mortgage-backed securities and longer-dated Treasury securities, have helped to bring mortgage rates to historically low levels and support the housing market. We are seeing signs of stabilization and even recovery in markets across the country. (See S&P/Case Shiller Table). In the last quarter of 2012, overall real residential fixed investment increased at a respectable15.3 percent. Such stabilization and recovery provides a foundation for growth, but is unlikely to provide a sharp boost to growth in the near future.

- S&P/Case-Shiller Home Price Index for 20 Major Metropolitan Areas (Jan 2000 = 100)

Metro Area	November 2012 Level	Monthly Change	Annual Change
Atlanta	95.68	0.1%	7.6%
Boston	153.74	-0.9%	2.3%
Charlotte	115.41	-0.3%	5.1%
Chicago	113.35	-1.3%	0.8%
Cleveland	100.68	-0.8%	1.8%
Dallas	120.55	-0.1%	5.7%
Denver	134.50	0.4%	7.8%
Detroit	80.33	-0.3%	11.9%
Las Vegas	100.56	0.4%	10.0%
Los Angeles	176.58	0.4%	7.7%
Miami	151.13	0.8%	9.9%
Minneapolis	126.41	1.0%	11.1%
New York	162.86	-1.1%	-1.2%
Phoenix	124.16	1.4%	22.8%
Portland	142.13	-0.2%	6.7%
San Diego	163.58	0.9%	8.0%
San Francisco	146.23	1.4%	12.7%
Seattle	142.53	0.5%	7.4%
Tampa	133.77	-0.2%	6.8%
Washington	189.11	-0.6%	4.4%

Sources: S&P Dow Jones Indices, Fiserv, and WSJ.

The housing market also may have an important impact on small businesses. To the extent that potential entrepreneurs rely on housing wealth as a source of capital for starting businesses, stabilization and recovery of the housing market also is significant for small business formation. The Census Bureau's 2007 Survey of Business Owners provides evidence on this linkage: "62.0 percent of employer business owners reported tapping into their personal savings to start their businesses, and 8.3 percent reported using a home equity loan taken out against their personal residences....Among the most recently formed firms, personal savings and home equity were even more important, with 67.1 percent of firms using personal assets or savings and 12.4 percent using a home equity loan," (Federal Reserve Board, *Report to Congress on Availability of Credit to Small Businesses*, September 2012, p. 52).

In addition, access to credit can be crucial for the health of the housing market and for new business formation and expansion. With the onset of the financial crises, credit standards for all types of borrowing increased significantly, and credit became difficult to obtain.

Recently, we appear to be making some progress on the credit availability front. The 2012 Senior Loan Officers Surveys from the Federal Reserve, for example, suggest that lending standards are becoming less restrictive. In addition, the National Federation of Independent Businesses (NFIB) found in their most recent survey: "Only 1 percent [of small businesses surveyed] reported that financing was their top business problem, tied for the lowest reading in survey history, compared to 23 percent citing taxes, 19 percent citing weak sales and 21 percent citing regulations and red tape," (NFIB, *Small Business Economic Trends*, January 2013, p. 2).

While credit access appears to be less of a concern than a few years ago, investment spending continues to face a number of headwinds, including those cited in the NFIB survey above. Real nonresidential fixed investment and spending on equipment and software grew by roughly 9 percent in 2012. Surveys suggest, however, that firms are scaling back their investment plans for 2013. The latest Duke University/*CFO Magazine* survey (December 2012) finds that CFOs in the US are forecasting only a 2.5 percent increase in investment spending in the year ahead. In contrast, in December 2011, they forecast a 7.8 percent increase for 2012. A survey of large firms just reported in the *Wall Street Journal* (Scott Thurm, "Companies Fret over Uncertain Outlook," February 11, 2013) also suggests a scaling back of investment plans: they forecast 2 percent increase in investment spending for 2013, in contrast to their report of an 8 percent increase during the first three quarters of 2012.

Federal government policies, the federal budget, and costs of health care are among the top concerns reported in the most recent Duke/*CFO Magazine* survey. There is evidence that uncertainty related to these types of policy concerns has been an important headwind to a more robust recovery.

My colleague Steven Davis and his co-authors Scott Baker and Nicholas Bloom ("Measuring Economic Policy Uncertainty," January 2013) have created an index of Economic Policy Uncertainty (EPU) and found that since the 2008 financial crisis, the EPU has risen considerably and that the increase has been "driven mainly by tax, spending, and healthcare policy uncertainty," precisely the factors mentioned in the Duke/*CFO Magazine* survey. They estimate that the increased policy uncertainty that occurred from 2006 to 2011could have reduced GDP by up to 2.3 percent, investment by 14 percent, and employment by 2.3 million jobs.

Since so much has already been written about the fiscal cliff and fiscal uncertainties, I want to provide a concrete illustration of the health care policy uncertainty weighing on business is related to the Supreme Court ruling that permits states to opt-out on Medicare. As described in the *Wall Street Journal* earlier this week (Louise Radnofsky, "In Medicaid, a New Health-Care Fight," February 11, 2013): "If states don't expand the Medicaid programs, the cost of covering millions of uninsured full-time workers will fall to employers. But state lawmakers also worry their budgets can't absorb the costs of participating over the long term." Amanda Austin, director of federal public policy for the National Federation of Independent Business, which brought the Supreme Court suit against the law, is quoted: "Business owners may be exposed [to higher costs] if the [state Medicare] expansion does not go through....On the other hand, business owners are generally concerned from a macro-entitlement perspective that these costs are going to be passed onto businesses indirectly." Obviously, this type of uncertain does not help revive economic growth.

Reducing Policy Uncertainty and Pursuing Pro-growth Policies

Going forward, it is crucial for the Congress and the Administration to understand the toll that policy uncertainty is taking on the economy. Clear, clean resolutions of uncertainty about federal fiscal and regulatory policies would undoubtedly help to spur recovery. It is not only the resolution of uncertainty that is important, but also how it is resolved. In particular, the government should be examining all of its policies through the lens of economic growth and focus on pro-growth policies.

I will give only a few illustrations of the many pressing policy issues we face. First, the tax system should be seen not simply as having important consequences for government revenue, but also for economic growth. Corporate tax reform, for example, should be a priority on a pro-growth agenda. Corporate taxes are relatively high in the US compared with most other major countries and the corporate tax system is extraordinarily complex.

Recent research suggests that corporate taxes reduce investment and entrepreneurship. "The Effect of Corporate Taxes on Investment and Entrepreneurship," by Simeon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer (*American Economics Journal: Macroeconomics*, July 2010) examines the corporate tax rates that new businesses face in 85 countries. The authors conclude: "Our data reveal a consistent and large adverse effect of corporate taxes on both investment and entrepreneurship. A 10 percentage point increase in the first-year effective corporate tax rate reduces the aggregate investment to gross domestic product (GDP) ratio by about 2 percentage points (mean is 21 percent), and the official entry rate by 1.4 percentage points (mean is 8 percent)."

Second, on government expenditures, I believe it would be more productive to move the debate away from the broad "austerity" vs "stimulus" discussion and redirect attention to the most important issue, namely, boosting sustainable economic growth. In a short-term accounting sense, more government expenditure will temporarily raise measured GDP but, of course, this has to be weighed against the costs of the project that will be borne by taxpayers.

The key question is whether such expenditure can help support sustainable recovery in the private economy and what is its effectiveness in doing so. Japan, for example, has for two decades undertaken numerous rounds of government "stimulus." The result has been a tripling of the Japanese government debt to GDP ratio to an astonishing 250 percent and anemic growth. (Japan has also suffered from chronic deflation during this period, importantly contributing to its growth woes.) For infrastructure-type programs, for example, we should ask whether a particular project going to reduce a bottleneck and increase the productivity of the economy. Such a perspective could be very beneficial for shaping a pro-growth policy.

Third, when resolving regulatory uncertainty, it would be extremely valuable to undertake cost-benefit analyses. Executive orders from the Reagan Administration to the Obama Administration recognize the benefits and importance of subjecting regulatory change to cost-benefit reviews. Cost benefit analysis is crucial to ensuring reasonable and sensible outcomes of the regulatory rulemaking process. "Cost-benefit analysis should be understood as a method for putting "on screen" important social facts that might otherwise escape private and public attention." (Cass Sunstein, "Cognition and Cost Benefit Analysis," *Journal of Legal Studies*, June 2000, p. 1060). It provides a framework to investigate the likely consequences, both intended and unintended, of a proposed regulation and to assess the net impact on society and the economy as a whole.

Scholars and policy-makers associated with both sides of the aisle argue for the importance of cost-benefit analysis for improving regulation and regulatory reform. Robert Hahn (a senior staff member of the Council of Economic Advisers under Presidents Reagan and Bush) and Cass Sunstein

(President Obama's former head of the Office of Information and Regulatory Affairs) co-authored a paper in which they considered the question:

> "How can regulation be moved in more sensible directions? This is a large question, and we will not attempt to answer it thoroughly here. But it seems to us that much of the answer lies in improved institutions, and, in particular, in institutional reforms that increase the role of cost-benefit analysis in regulatory policy as a way of drawing attention to the likely effects of alternative courses of action....the commitment to cost-benefit analysis has been far too narrow; it should be widened through efforts to incorporate independent regulatory commissions within its reach. (Robert W. Hahn and Cass R. Sunstein, "A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis," University of Chicago Law School, Law and Economics Working Paper 150, April 2002, p. 3).

Thus, to increase the likelihood that we can break out of the "sideways slide," reducing policy uncertainty is important but resolving that uncertainty in ways that promote sustainable economic growth is just as critical. I will be delighted to take you questions.