Remarks
of
Dr. N. Gregory Mankiw
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I am delighted to be here. I very much appreciate the opportunity to speak with you today. I will take this time to discuss recent developments in the economy, and some of the challenges the nation faces going forward. I am also enough of a policy wonk that I want to discuss some larger issues about how fiscal policy should be evaluated, which apply not only to the President's policies but to economic policy more broadly.

When I arrived at the Council of Economic Advisers this spring, I viewed the economy as experiencing something similar to a tug of war. It was being pulled in opposite directions by several powerful forces of contraction and by some equally powerful forces of expansion.

On the contraction end of the rope were the shocks that the U.S. economy had experienced over the preceding three years: the end of the high-tech bubble and the consequent effects on wealth, consumption, and especially investment; the revelation of years of wrongdoing at some corporations; and the impact of the September 11 attacks and the subsequent uncertainties surrounding the war on terror and the conflict with Iraq. Other contractionary forces came from abroad. Slow growth in many of our trading partners, notably Japan and much of Europe, depressed our exports, and it continues to do so today. Given these events, it was remarkable that the U.S. economy was not in worse shape in 2002 and entering 2003, but this fact was of little consolation to people looking for work or to retirees who had seen their savings depleted by the stock market decline.

Pulling hard on the other end of the rope were the expansionary forces of monetary and fiscal policy—the Federal Reserve's series of interest rate cuts and the Administration's tax cut in 2001 and the stimulus package of 2002.

This past spring, it looked like the result of this tug of war was a stand-off—a draw between the forces of contraction and expansion. Growth had resumed after the end of the recession in November 2001, but the pace of growth was far from satisfactory. And of course the labor market remained, and still remains, lagging behind.

Because further policy action was clearly needed, the President pushed hard for the passage of his Jobs and Growth initiative. The purpose of this initiative was not only to help push the economy back toward its potential but also to raise this potential by improving supply-side incentives for work and investment.

Four months after its passage, the economy is now headed in the right direction. Earlier in the summer when the official forecast was made for the Mid-Session Review, growth was expected to come in at 2.3 percent for 2003, rising to 3.7 percent for 2004. This was a notable firming and far enough above potential to increase employment. This seemed like a reasonable but still optimistic prediction.

Most of the recent news has been better than we expected. The signs of a strong rebound are now numerous, with positive indications coming from retail sales, vehicles sales, disposable income, durable goods shipments and orders, and the ISM surveys of manufacturing and non-manufacturing activity. The most recent Blue Chip consensus forecast is significantly above what we forecast this summer.

A robust rebound in output growth would be a welcome change from the growth rates we have seen so far in this recovery. The CEA has estimated long-run potential growth at a bit over 3 percent, determined by growth in the labor force plus growth in labor productivity. Economic growth has generally been below potential in the current recovery, but we need growth above that potential to get unemployment back down.

The labor market often lags somewhat behind output in economic recoveries. But the disparity has been larger in this recovery than in most. One reason is that labor productivity has increased at a historic rate, with output per hour rising at an astonishing 3.8 percent annual rate from 2001 to 2003. This is more than a percentage point better than in the period of rapid growth in the late 1990s. In the short run, this productivity growth translates into weak employment growth: by sheer arithmetic, higher productivity means that firms need fewer workers for any given amount of output. In other words, we need even stronger growth to see rising employment.

But no one should lament rapid productivity growth. Over the long term, productivity growth is the key determinant of growth in real incomes and living standards. Indeed, the relationship between productivity growth and real wages is one of the more robust ones in economics. So make no mistake: positive news about productivity is good news for the American worker. Productivity growth is the macroeconomic reflection of the superior performance of the U.S. economy. Many nations would love to have America's so-called "problem" of high productivity growth.

The long-run relationship between productivity and real incomes is well-known. What is sometimes overlooked, however, is that even in the short run, strong productivity growth has been good for workers. We are now about 10 quarters after the start of the recent recession. Real wages (as measured by real average hourly earnings) are up 2.9 percent from the start of 2001. By contrast, in a typical recession, after 10 quarters real wages have usually only just recovered to their pre-recession levels.

This strong real wage growth is easy to overlook because it is attributable in large part to low inflation, rather than rapid nominal wage growth. The Fed gets much of the credit for the current low inflation, but its job has been made easier by strong productivity growth, which has been holding down growth in unit labor costs.

The sources of strong productivity are hard to identify. Despite numerous research studies, economists are not good at predicting productivity growth, or even explaining fluctuations in it after the fact. Good economic policy undoubtedly plays a role. Many market economies have failed to experience a productivity revival in recent years, suggesting that the pro-growth orientation of American economic policy is in part responsible for our productivity performance.

In contrast to explaining productivity, it is easy to understand the forces that have made this recession short in length and shallow in depth, as judged by the decline in real GDP from the peak to the trough. Monetary and fiscal policy – the two main levers of macroeconomic stabilization policy – were both actively engaged in this cycle, both leaning hard against the headwinds that emerged from the late 1990s.

I will not say much today about monetary policy. This is not to diminish in any way the crucial role of the Federal Reserve in helping to counter the adverse forces in this recession. But fiscal policy is my beat as CEA chairman, so that will be the focus of my comments.

The U.S. economy is remarkably flexible and resilient. Had we done nothing, the economy would eventually have recovered from the recession. But the actions the President took made the recession less severe.

As the President has discussed, analysis done within the Administration has shown how his tax cuts have substantially offset the series of adverse shocks that have been buffeting the economy. Simulations of a conventional macroeconomic model show that, without the tax cuts, the level of real GDP would have been about 2 percent lower in the middle of 2003. About 1.5 million fewer people would have jobs today. The job market is not what we would like it to be right now, but it would have been worse without the Administration's actions.

One can view the short-run effects of these tax cuts from a classic Keynesian perspective. The tax cuts let people keep more of the money they earned. This supported consumption and thus helped maintain the aggregate demand for goods and services. There is nothing novel about this. It is very conventional short-run stabilization policy: You can find it in all of the leading textbooks.

But in addition to providing a Keynesian stimulus to consumption, the tax cuts also addressed today's most important cyclical problem: sluggish investment. As you know, the 2001 recession was unusual in the degree to which weak investment was a central driving force. Investment weakened substantially starting in 2000, as firms joined stock-market investors in reevaluating prospects for future earnings growth and developed a reduced tolerance for risk in the aftermath of the bubble. The corporate governance scandals may also have played some role in reducing the willingness of corporate CEOs to take on risky projects.

To counter these developments, the Administration's tax cuts were designed to give businesses increased incentives to invest. The package included lower taxes on dividends and capital gains; enhanced expensing for small businesses; temporary bonus depreciation; and elimination of the estate tax. In addition, lower individual tax rates help sole proprietorships, partnerships, and S corporations. For these taxpayers, income flows through to their individual tax returns. All of these initiatives lower firms' cost of capital.

The tax cuts have thus supported demand—both consumption and investment. This will help bring the economy back closer to potential. We are not there yet, and clearly not so in the labor market. But there are indications that the economy is firming, and we expect progress in the labor market to follow.

The Administration's tax cuts, however, should not be viewed only from a short-run perspective. They were also designed taking into account the important long-run, supply-side effects.

Lower marginal tax rates on both labor income such as wages and on capital income such as dividends and capital gains improve incentives and so boost growth in potential output. We will not just get back to potential; instead, we will have a new and better long-run growth path.

Lower marginal tax rates on wage income will increase work effort, while lower taxes on capital income will increase investment and thus capital accumulation. More capital means that each worker has more tools and is more productive, and improved productivity means higher wages. In addition, lower taxes on dividends and capital gains, as included in the most recent tax bill, also reduced the unequal tax treatment of corporate and noncorporate capital. Moving toward a more level playing field between different types of capital will increase efficiency, as capital is allocated with more of a focus on profit and less concern for tax avoidance.

The qualitative effects of these tax changes on the short-run output gap and on long-run potential output are not controversial. There is less agreement on quantifying these effects—how many jobs were created, how much growth was increased, and so on. To answer these questions, one would normally turn to a macroeconomic model such as those maintained by private forecasting firms, the Federal Reserve, and other institutions. I view such models as being very useful at relatively short time horizons such as one or two years. Over this horizon, demand-side effects predominate.

These models, however, typically devote less attention to supply-side effects. So beyond 18 or 24 months when supply-side factors become increasingly important, one should be careful to recognize the limitations of these models.

This issue is of great relevance for “dynamic scoring.” Tax economists are quite good at estimating the static score of a tax cut, which you can view as the “sticker price.” But it is very likely that this sticker price is an overestimate of the true budgetary cost. To estimate the true cost of a tax cut, we need to know the long-run effects of a policy on tax revenues. Tax revenues depend on potential output, which in turn responds to tax incentives. Unfortunately, macroeconomic models of the supply side are still very much works in progress. I will return to this issue in few minutes.

Even more difficult is evaluating who bears the burden of the tax system, or equivalently, who wins and who loses from any tax cut. Most discussion of distributional burdens is fundamentally flawed. It is premised on a misunderstanding of the basic lessons of microeconomics.

The most important lesson to keep in mind, which is not at all controversial among economists, is that the person who bears the burden of a tax is not necessarily the person who writes the check to the IRS. In technical terms, the economic incidence of a tax can differ from the statutory incidence, and usually does.

A common example is the case of payroll taxes. By law, employers and employees both pay about 7½ percent of wages for Social Security and Medicare taxes. Yet we know that this even split dictated by statute does not determine who really bears the burden of the tax. The true distribution of the burden depends not on the laws of Congress but on the laws of supply and demand. Many economists believe that workers bear most, or even all, of the burden. That is, payroll taxes most likely reduce workers' take-home pay by about 15 percent.

The incidence question is particularly tricky when analyzing capital income taxes. Let me give you an example I use with students, which is fanciful but instructive. Consider a tax on ice cream machines. This is a tax on capital—a particular type of capital. Who bears the burden of this tax? One might be tempted to think that it is just the owner of the ice cream factory, who writes the check to the IRS. If this person is well-off, then this tax might look like progressive. It might appear to shift the burden of the tax system toward the rich.

Yet there is more to it than that. In response to the tax, the ice cream company will invest in fewer ice cream machines. With fewer ice cream machines, less ice cream will be produced, and prices will rise. This will affect consumers—everyone who likes ice cream will pay more and bear part of the burden of the tax. Some people won't want to pay more and may stop eating ice cream. They won't pay a higher price, but they will still bear a burden. Economists call this an excess burden, or the deadweight loss of the tax.

Consumers are not the only ones who are affected. With fewer ice cream machines and less output, there will be reduced demand for labor, so workers in the ice cream industry are also hurt. Employment in ice cream factories will fall. So too will the real wages for the remaining workers, who now have fewer machines to work with and are thus less productive.

And even this is not the end of the story. There are other companies that manufacture ice cream machines, and both the owners of those companies and their workers are worse off. And then there are the companies that make hot fudge. In the end, the tax on ice cream machines affects numerous people, even though the owners of the ice cream companies—Ben, Jerry—are the only people who, by statute, pay the tax.

Consider now the Jobs and Growth Bill the President signed in late-May. This law lowered the tax rate on dividends and on capital gains. That is, it reduced the tax on capital, because dividends and capital gains are just the reward from capital investments, such as ice cream machines. Who benefits from this tax cut? Is it only the owners of the capital—the shareholders who will write a smaller check to the IRS?

When you see tables purporting to show the distributional impacts of the tax cut, you should ask how they answer this question. Most often, when analyzing capital income taxes, they consider only who writes the check. This is also the answer implicit in criticisms of the tax cut that claim that it disproportionately favors the rich owners of capital.

I have a very different view. By the same logic as with the tax on ice cream machine, all Americans will benefit from the dividend tax cut, not just the owners of capital. This is because a lower tax rate on capital income will lead to more investment and thus more capital. As a result, more workers will be hired to staff the new factories, while existing workers will have more capital to work with and thus be more productive. Wages will rise. Workers who do not own stock and who will never receive a penny of dividends will enjoy a higher standard of living.

What about shareholders—the owners of capital? Their after-tax rate of return will initially rise. With the tax cut, they pay less tax on existing investments. But the higher after-tax returns will induce more investment. For owners of capital, more capital means that the return on capital (before taxes) goes down. You may recognize this as simply the law of diminishing returns: When there is more capital, each unit of capital is worth less. This is part of the mechanism by which the benefits of the tax cut over time shift from the owners of capital to workers.

Some economic models—in particular the so-called neoclassical growth model—suggest that in the long run, the rate of return may fall by the full amount of the tax cut. Owners of capital are left with their initial after-tax rate of return. In this case, all of the benefit of the capital tax cut flows to workers in the form of higher productivity and higher wages. I admit that this conclusion is controversial among economists. But, in my view, it is closer to the truth than the polar opposite assumption that all of the tax cut stays with the owners of capital.

This economic analysis may seem complicated, but the bottom line is simple: evaluating a tax change, assessing who wins and who loses, is not the same as seeing who writes the check. The economy adjusts to any tax change, and these adjustments are crucial for understanding the distribution of the gains and losses. The tax policy of this Administration has been aimed at restoring growth and promoting capital accumulation. This benefits all Americans.

As I have already mentioned, another area in which the standard analysis of tax policy misses the mark is in the projections of the budgetary costs—the "scoring" of a tax bill. The standard analysis assumes that changes in tax policy do not have any macroeconomic effects. That is, tax cuts are assumed not to affect economic growth, either in the short run or in the long run. It is as if a tax on ice cream machines were assumed to have no impact on the market for ice cream.

Although it is hard to estimate the impact of a tax cut on output, we know that it is not likely to be zero. The standard "static scoring" uses a precise but wrong answer—zero—to derive the "sticker price" of a tax cut. Conventional scoring does allow for the possibility that individuals change behavior in response to tax cuts. For a capital gains tax cut, for example, conventional scoring recognizes that capital gains will be realized more frequently. But the analysis does not recognize any macroeconomic effects on investment or output.

As a result, the true price of a tax cut differs predictably from the sticker price, as higher growth will lead to more revenue. I do not believe the revenue feedback is enough to fully pay for a tax cut in most cases, but it is likely to make a meaningful offset. For looking at the short-run costs of tax policy, the dynamic effects need not rely on supply-side phenomena; they can be based on the simple Keynesian demand-side effect of fiscal policy. Over a longer horizon, supply-side effects will be more salient.

I do not think anyone can be confident about how much the true "dynamic score" of a tax change differs from the "static score." This is a hard problem. It is no criticism of people who work on scoring that they have not yet perfected the art, particularly in light of the time and resource limitations they face.

One thing to keep in mind, however, is that because of their effect on capital accumulation and thus on potential output, capital tax cuts are likely to cost less over the long run than other types of tax cuts. That is, a tax cut that lowers the cost of capital will widen the tax base by more than a tax cut of equivalent size on labor income.

Of course, the expansionary effects of the tax cuts will be offset to some degree by the effects of the budget deficits that arise from lower revenues. Deficits can raise interest rates and crowd out of investment, although I should note that the magnitude of this effect is much debated in the economics literature. The main problem now facing the U.S. economy is not high interest rates, but at some point continued deficits would matter and could impede growth. This is why, as the President has said, spending restraint is so vital.

The Administration would prefer not to have deficits, but deficit reduction is only one of many goals. Reversing the tax cuts today, as some have suggested, would depress growth and job creation. This is a matter of priorities: In the face of a shrinking or barely growing economy, an investment slowdown, and continued job losses, the President made growth and jobs his number one economic priority. There are others who think he should make deficit management the top priority – but the Administration does not share that point of view. Deficits are worrisome, but not as worrisome as an economy that is not growing and is rapidly shedding jobs.

It is also important to be aware of how these deficits arose. About half of the change in the fiscal outlook since the President took office is attributable to the weak economy, including the stock market. About a quarter is due to higher expenditures, mainly on homeland security and defense. The last quarter is due to reduced revenue from the tax cuts. And these estimates are based on static scoring, so they surely overstate the role of the tax cuts.

What is important is to have a plan under which the deficits shrink over time relative to the size of the economy. This is the case under the President's policies. The deficit as a share of GDP is projected to diminish by more than half over the next five years.

The most important fiscal challenge facing the United States is not the current short-term deficits, which will shrink, but instead the looming long-term deficits associated with the rise in entitlement spending as the baby boom generation retires. This challenge is simply the march of demographic destiny combined with our pay-as-you-go entitlement system. It is not a new challenge, and it was not created by tax cuts or solved by previous tax increases. The President's Budget has correctly called this issue "the real fiscal danger."

The President’s goal is to ensure that Medicare and Social Security are available for future generations, while keeping our promises to current retirees and those approaching retirement. To do this, these programs must be modernized, because current policies are not sustainable in the long run.

The President has talked frankly about the need to modernize Social Security and Medicare, when the easier thing to do politically would have been to remain silent. After all, Social Security has been called the third rail of American politics, but the President has grabbed onto this rail and insisted that it be discussed. He has taken the bold step of talking about personal accounts in Social Security, to make sure that beneficiaries have an ownership stake in the system.

The President has similarly called for Medicare reform, when the easy path would have been to simply add prescription drugs to the existing system. Instead, the President has asked for a new system that includes greater choice for seniors and competition among private providers.

We do not yet have all the answers to the problems posed by entitlement costs, but we are hard at work. We invite others to work with us. These challenges are so great that we will likely need a bipartisan consensus to push forward significant reforms.

These longer-term issues, however, should not blind us to the immediate needs of the economy. The President came into office inheriting an economy that was on the brink of a recession. He has responded vigorously to the challenges and, as a result, the current outlook for the U.S. economy is bright, not only for today's workers but for future generations as well.