

“The View from the Administration”
Remarks at Macroeconomic Advisers’ 23rd Annual Washington Policy Seminar
Jason Furman
September 12, 2013

Remarks as Prepared

Thank you for inviting me here today. In the past Macroeconomic Advisers has always been very good about inviting the Chair of the Council of Economic Advisers to come and speak about the Administration’s perspective. And, in the past, when the Chair was unable to come, Chris Varvares eventually got around to inviting me as a backup. It is exciting to finally be your first choice.

I have been the Chair of the Council of Economic Advisers for just over a month now. And during that time auto sales have increased robustly, manufacturing has expanded, gasoline prices have fallen and the economy has added 169,000 jobs (I know many of you focused on the negative revisions for June and July, I would just note the fact that Alan Krueger was Chairman during that time). I would not, however, want to overstate my case and claim that my becoming Chairman of the Council of Economic Advisers is the only reason for all of these favorable macroeconomic developments.

I want to use today’s remarks to focus on four general topics: First, the major turnaround in the last five years; second, the pace of the current economic recovery; third, the role of fiscal policy, and finally, the President’s proposal for a Grand Bargain for Growth, particularly discussing our thinking on business tax reform.

The Major Turnaround in the Last Five Years

When I look back at the more than five years I have been working for President Obama we have seen some major changes in the economy. I started with him on the campaign and I vividly remember this time five years ago. Fannie and Freddie had just been put into conservatorship. We had just learned that the economy lost 84,000 jobs in August which seemed scary at the time (subsequently that was revised down to 270,000 jobs lost). And Lehman Brothers and AIG were teetering on the brink.

It only got worse when we entered the transition. As we were working on the Recovery Act we learned that the economy lost 533,000 jobs in November which once again seemed scary at the time and once again was subsequently revised down to 775,000 jobs lost. And as we all know the parade of other statistics, perhaps none more striking than the \$16 trillion in wealth—one quarter of all wealth—that was destroyed between the third quarter of 2007 and the first quarter of 2009.

I realize I may not be the first speaker you have had from the Administration to make these points, and I promise that if you invite me back next year I will not repeat them, but with all the press on the fifth anniversary of Lehman Brothers it is hard to not be struck by how far we have come. While more work remains to be done, a great deal of progress has been made in digging out of the deep

hole that was left in the wake of the financial crisis. Last Friday, we learned that August marked the 42nd consecutive month of private sector job growth, with businesses adding a total of 7.5 million jobs over that period. And the job growth has been very steady, 2.3 million jobs in the last twelve months, 2.3 million jobs in the twelve months before that, and 2.1 million jobs in the twelve months before that. The unemployment rate has fallen by three-quarters of a point per year, a relatively rapid rate, and while unacceptably high at 7.3 percent is now back to where it was in December 2008. Economic growth has been steady, America has a strong auto industry, our banks are increasingly well capitalized and we have seen housing prices and construction recovering.

The Current State of the Recovery

But I wanted to look more closely at the economic recovery and in particular focus on three important questions:

First, why have we seen the participation rate fall and what is likely to happen to it going forward?

A good deal of work has been done in attempting to explain the decline in the labor force participation rate. We know that there is a long-term demographic trend as the baby boom ages. We know that separate from this pure demography there is a longer-term trend towards declining participation, one that we have seen steadily for men for over sixty years and women for over a decade. And finally, we also know that there is a strong cyclical component to the participation rate.

The 2013 *Economic Report of the President* estimated that a bit more than half of the decline in the labor force participation rate since 2007 reflected the underlying demographics, and a bit less than half was cyclical; I believe MacroAdvisers put out an estimate just this week that was very similar. But further work on this topic is certainly warranted.

So far all of these factors have worked together to reduce the participation rate, but a key question is what will happen to the participation rate as the economy continues to recover discouraged workers will return to the labor force and that pressure will partly or fully counteract the longer-term trends.

Second, why has the core inflation rate remained relatively steady—despite a continued unemployment gap? The unemployment rate is currently about 2 percentage points above CBO's estimate of the NAIRU. But the core inflation rate is relatively stable and not falling—as would be predicted by a conventional expectations augmented Phillips curve. Part of the answer appears to be the composition of the elevated unemployment rate, notably the fact that while short-term unemployment (those unemployed 27 weeks or less) is just above its pre-recession average, the long-term unemployment rate remains elevated and is responsible for almost the entire gap between the current rate and the NAIRU. What appears to be the case is that these long-term unemployed exert less influence on wage and price increases. But this just raises additional questions and trying to understand the dynamics of long-term unemployment, the remedies for it (many of which are not necessarily specific to the long-term unemployed and are just stronger aggregate demand and more job creation), and how we expect the different components of the unemployment rate to vary over the cycle.

The third question is why has economic growth, while steady, come in at a pace that none of us can be fully satisfied with? I think there are four reasons:

1. *A slowing of the growth rate of the labor force*, for the reasons I discussed in the context of the longer-term trend in the participation rate. CEA Member Jim Stock's work in the most recent *Economic Report of the President* showed that for several decades now we have seen a pattern of the trend growth in each recovery being slower than the previous recovery. As an aside, I should point out that this fact is an important economic motivation for commonsense immigration reform.
2. *The nature of the initial shock*, particularly a financial market shock which led to a prolonged period of deleveraging and precluded the normal drivers of a rapid recovery, like rapid growth in housing and autos. We know from a range of work, including the body of Reinhart and Rogoff's work that is still intact and highly informative, as well as from structural time series models done by Stock and Mark Watson, that recovery from financial crises is generally more challenging.
3. *The subsequent shocks*, including the European sovereign debt crisis, the tsunami and nuclear accident in Japan, the disruption of Libya's oil supply, extreme weather and droughts, and fiscal contraction at the State and local level. I suspect many of the forecasters in the room have seen years where growth rates came in below their forecasts and would identify many of these factors for the shortfall.

Fortunately we have also had some positive shocks, one of the most important of which is the dramatic slowdown in the cost of healthcare—which is now growing at the slowest rate in fifty years. The recently released Kaiser Employer Health Benefits Survey showed that in 2013, premiums for employer-sponsored insurance grew at about a third of the rate that was observed during the late 1990s and early 2000s.

4. *Unforced errors by Congress in our fiscal policy*, including repeated and unnecessary brinksmanship around fiscal issues and, most recently, failing to address the sequester and thus contributing to an even larger fiscal contraction. And that brings me to my third major topic, fiscal policy.

The Status and Outlook for Fiscal Policy

There are two really important facts about the deficit. First, the deficit is falling very rapidly. It has fallen from a high of 10 percent of GDP in FY 2009 to what looks like it will come in at about 4 percent of GDP this year. That is the fastest pace of deficit reduction we have seen in this country other than the end of World War II and a remarkable half of that total deficit reduction took place in just one year: FY 2013. Amidst that fiscal climate, we really are fortunate to have had a private sector that was leading the way in the economic recovery and keeping our overall growth rate steady.

The good news for the short-run macroeconomic outlook is that that we have digested most of this fiscal contraction and, absent another round of Congressional brinksmanship, should at worst face a more neutral fiscal stance going forward. The bad news is that while we have made substantial progress on the deficit, including over \$2.5 trillion in total deficit reduction the majority of it in the form of spending cuts, we are still on a current policy course that would see deficits rising back above 3 percent of GDP by the end of the decade and the debt rising as a share of GDP. That is much better than the projections even one year ago, in part due to the fact that the CBO reports that it “has made a series of downward adjustments to its projections of spending for Medicaid and Medicare,” with combined spending on the two programs now expected to be about \$200 billion lower in 2020 than what it forecast three years ago, but we can certainly do better.

There are some macroeconomic challenges that are deeply vexing and present insoluble dilemmas, the most classic being the impossible trinity of free capital flows, fixed exchange rates and sovereign monetary policies. Some countries in the world today are dealing with equally painful dilemmas around how to promote economic expansion in the face of capital flight and limited ability to borrow against large deficits. In the United States what is so vexing is not the difficult or insoluble dilemma we face but just the opposite—how simple and obvious the macroeconomics of the solution is. And that makes the Congressional resistance to the solution even more frustrating.

Just about any economic textbook, or any model any of you use, would tell you that the answer to our macroeconomic stance is less fiscal contraction upfront and more deficit reduction over the medium and long term. Nearly a year ago the President put forward a framework that does just that. It provides relief for the sequester and upfront jobs measures like investments in infrastructure, teacher jobs and small business tax cuts. And it more than pays for these with additional deficit reduction, including entitlement reform and tax reform.

Compared to the sequester, the President’s proposals have less deficit reduction in FY 2014 and FY 2015 when the economy still needs help, but substantially more deficit reduction thereafter. In 2021, the President’s framework has \$224 billion in non-interest deficit reduction as compared to \$109 billion from the sequester in that year and by 2023 the deficit reduction under the President’s plan grows to \$296 billion while the deficit reduction under the sequester falls to \$15 billion. As a result, the Congressional Budget Office estimated that the deficit falls to 2 percent of GDP in 2023 under the President’s approach, consistent with falling debt as a share of GDP.

And it is not just the quantity of fiscal policy that matters, but the quality. The sequester is cutting investments in future growth like infrastructure, research and education. It does nothing to reform entitlements and only produces about \$85 billion from Medicare savings all on the provider side in the first decade and zero Medicare savings in the second decade (because the sequester ends after 2021). In contrast, the President’s framework would preserve and enhance those investments while producing over \$350 billion in Medicare savings in the first decade growing to over \$1 trillion in savings in the second decade, including meaningful structural reforms. At the same time, limiting tax expenditures for high-income households would reduce distortions in the tax code and raise additional revenue.

None of this is rocket science. And the most immediate two fiscal priorities facing Congress is even easier: pass a budget that continues to fund the government and pay the bills we have already

incurred by raising the debt limit. That is the bare minimum, do no harm approach to the economy—but there is a lot more we can and should do to support private sector job creation and economic growth. Which brings me to my final topic: the President's Grand Bargain for Growth.

The Grand Bargain for Growth and Business Tax Reform

In July the President laid out a Grand Bargain for Growth which centered around an agenda that is based on the input we have gotten from many business leaders, economists, and other experts—specifically combining business tax reform with job-creating investments like infrastructure and training.

Today I want to go a little deeper on the business tax reform component of this Grand Bargain. While there is substantial scope for simplification, improvement and additional high-income revenue on the individual income tax side, I think the biggest macroeconomic gains from tax reform are likely to come on the business side. Our business tax code is increasingly distorted. Most basically, we can measure this distortion by the fact that the United States now has the highest corporate tax rate in the world. Or we could equally well note that the United States has among the narrowest corporate tax base in the world. The combination of the two of these present not just a challenge but also yet another obvious opportunity to remedy both problems simultaneously while not making our deficit any worse.

At a deeper economic level, the guiding principal of our business tax reform efforts is to develop a tax system that is more neutral so that decisions are being made for business reasons and not for tax reasons and capital is flowing to the best possible uses. That means more neutral about different forms of investment so that we are not taxing investment in a manufacturing buildings at 32 percent while taxing investment in petroleum structures at 9 percent. It also means being more neutral about the financing of this investment, in particular addressing the fact that the United States currently has the highest tax rate in the world on equity financed investment but the lowest tax rate in the world—in fact an effective subsidy—for debt financed investment. And it means greater neutrality about how a business organizes itself, reducing or ending the tax advantages that many large pass-through entities face so that forms of business organization are chosen on the merits and not for tax reasons. And finally it means greater neutrality about decisions about investing in the United States versus overseas, rather than a tax code that rewards investment and reinvestment overseas.

The conventional lower the rate and broaden the base mantra is consistent with the economic perspective on neutrality. A broader base lessens the non-neutralities between different forms of investment. And a lower rate makes all of the tradeoffs between debt and equity or worldwide and territorial tax systems considerably less painful.

I believe there is now increasing convergence around the basic underlying ideas in business tax reform. That includes agreement that tax reform should be revenue neutral, which the Administration defines as on an ongoing basis, a point I will come back to. It includes agreement that the rate be lowered to the mid-twenties through the elimination of tax expenditures and structural reforms that include some combination of depreciation, the taxation of large pass-throughs and the full deductibility of debt. And it includes a hybrid system for taxing international

earnings, although there remain important differences on just where to strike the balance in that hybrid—with the President proposing that it be done through a minimum tax on the earnings of foreign subsidiaries of U.S. corporations. Finally, there is broad agreement that business tax reform should not raise taxes on small businesses—and in fact should cut them—which was one of the basic principles of the President’s tax reform framework.

The President would prefer that business tax reform be part of the larger fiscal agreement I was describing earlier, including a revenue-raising reform of individual taxation, entitlement reform and upfront jobs measures. But given the difficulty of getting agreement on such a framework, in July he proposed that we focus on what should be even more achievable and is even more urgent: a Grand Bargain for Growth—essentially saying we could start with a balanced subset of this broader plan that combines business tax reform with upfront investments in infrastructure and other jobs measures. This approach would still abide by the principal of ongoing revenue neutrality but would use the one-time revenue generated by the transition to a new tax system and use it to finance the one-time investments in infrastructure.

At this point the biggest obstacle to this approach appears to be the argument that we should also lower the individual tax rate to the mid-twenties. While we agree with the stated motivation that reform should protect and support small businesses, we strongly disagree that this is the right way to do it—or even that this is actually about small businesses. As a matter of pure economics, our goal should be to have the integrated rate on corporate and noncorporate businesses roughly the same. With a corporate tax rate in the mid-twenties and dividends and capital gains at 20 percent, that is roughly neutral with the current top rate of 39.6 percent. Moreover, while we have concerns about businesses moving due to higher tax rates, we have considerably less concern that large numbers of high-income individuals will leave the United States because of the higher individual tax rate.

The goal of lowering the individual rate to the mid-twenties, or even anything close to that, is also impossible from the standpoint of budget arithmetic. It would cost over \$5 trillion and there simply are not enough base broadeners from high-income households to fully pay for this—meaning that the cost would need to come at the expense of the deficit or at the expense of higher tax payments by middle-class families.

All of this is why the President’s business tax reform plan focuses its small business tax reductions on actual small businesses that are investing and creating jobs, for example by raising expensing, rather than by cutting the individual rate which is so costly because most of its benefit just goes to high-income individuals. We think our approach is a promising one and look forward to working with Congress on it.

In Conclusion

We have made enormous progress in the last five years and really turned the economy around and started moving it in the right direction. But we have a lot more that we need to do. The good news is that much of what we need to do is relatively straightforward, basic economics. The bad news is that Washington is sometimes incapable of proceeding on relatively straightforward, basic

economics. But I am in this job because I remain an optimist and look forward to the opportunity to continue to work to advance these important issues.

Thank you, I would now like to take your questions.