The 2018 Economic Report of the President
Testimony before the Senate Budget Committee
By the Chairman of the Council of Economic Advisers Kevin Hassett
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Chairman Enzi, Ranking Member Sanders, and Members of the committee, thank you for inviting me to appear before the Committee today. It is a pleasure to discuss the 2018 *Economic Report of the President* and explain the economic rationale behind this Administration's economic priorities. I look forward to explaining how the "dismal science" of economics should make you an optimist about how the U.S. economy is performing now and could perform even better if policies along the lines of those advocated by this Administration were implemented.

Today, appearing before this Committee of the 115th Congress, I intended to focus my testimony around a role assigned to the Council of Economic Advisers by the 79th Congress in the Employment Act of 1946. That role is to "gather timely and authoritative information concerning economic developments and economic trends, both current and prospective."

Perhaps no document better embodies the Council's attempt to fulfill this function than the *Economic Report of the President*. Hundreds of pages, the *Report* analyzes economic issues to which the Administration has developed policy responses – as well as those issues for which the Administration's policies are not yet final. It is for this reason that the *Report* serves as the basis of my testimony today.

The economy in the United States remains in flux. Though we are confident in the rationale behind our policy-inclusive forecast, there is only one forecast that can be said with certainty in economics: the economy of the future will not be the economy of the present. Staring into the future, as an economist, uncertainties abound. The question is whether these uncertainties materialize into opportunities for future Americans, or turn into risks that materialize to the downside and drag down the economy.

You might think of the whole of CEA's *Report* as laying out a framework for navigating some of the uncertainties now on the horizon in such a way as to turn them into tailwinds of opportunity rather than the headwinds of risks materialized to the downside. To understand the whole, however, it helps to understand each of the parts.

<u>Cyber</u>

You don't need much imagination to envision how America's Founders would have responded if America's merchants suffered at the hands of pirates. President Thomas Jefferson initiated one of America's first overseas conflicts, the First Barbary War, in response to the seizure of American merchant ships by pirates in North Africa. In 2016, however, malicious actors inflicted over $100 billion worth of damage to the U.S. economy. Rather than the seas, however, these malicious cyber actors attacked America and its businesses in cyberspace – where America's merchants now face threats from 21st century pirates.

As information technology has increased in its importance to the economy, so have the opportunities for malicious cyber actors to profit through illicit activity – at the expense of American businesses, households, and governments. And CEA's analysis suggests that there is a market failure that leads

private firms, which tend to face risks correlated with one another, to invest less in cybersecurity than would be economically optimal.

Cybersecurity matters for the economy now more than it ever has before – and this trend does not seem likely to reverse itself anytime soon. With cybersecurity poised to remain a topic of ongoing conversation here in Washington for some time to come, this Administration is advocating for better cooperation between the public and private sectors to ensure that cybersecurity risks are managed effectively now and in the future.

Taxes

With regard to taxes, I am pleased to say that the *Report*'s chapter on taxes lays out how and why the Administration has already delivered a policy that increases growth now and improves the well-being of Americans in the future as well.

Developed countries have competed to attract business by lowering corporate taxes for years. The 2018 *Report* shows how tax rates have trended downward since the year 2000, even as the corporate rate in the U.S. has stayed the same – until now. This left the U.S. in a position that was, from a tax perspective, increasingly not competitive. By lowering the corporate tax rate and reforming the corporate tax code, the Tax Cuts and Jobs Act (TCJA) has improved America's ability to attract businesses that create good jobs for their workers by competing in the global economy.

Indeed, according to the analysis in the *Report* (which includes analysis CEA staff have performed previously), the corporate dimension of the TCJA could increase annual household income by an average of $4,000.[1] In addition to the wage estimate CEA previously released, the Report's tax chapter includes a new estimate of the effect of the TCJA's changes to the individual tax code on growth. The individual changes, the analysis shows, could increase GDP by 1.3 to 1.6 percent after 10 years.

And if the tax cuts are made permanent, the Report's analysis shows, the resulting increase in GDP stands poised to add another $4.7 trillion to $7.4 trillion to the economy over the next decade.

Already, over 4.9 million workers received raises, bonuses, or improved benefits as of last week, by our calculations. Companies have already announced investments of over $200 billion, investments likely to increase growth and wages. But this is just the beginning of the benefits the TCJA stands poised to deliver: as only months have elapsed since the passage of this historic legislation, the U.S. economy is still in the process of adjusting to its newly competitive tax code. And we can only expect wages to continue to rise and growth to continue its increase as the U.S. economy settles into its new post-TCJA equilibrium. Forecasters continue to recognize the potency of the TCJA as a means to the end of increasing economic growth and improving the American economy in the future. For instance, the OECD recently raised its growth forecast for the U.S. in 2018 by four-tenths of a percentage point and its growth forecast for the U.S. in 2019 by seven-tenths of a percentage point. The TCJA, then, serves as an example for how policies enacted today can improve the economic outlook for the U.S. economy in the future.

[1] "Corporate Tax Reform and Wages: Theory and Evidence," White House Council of Economic Advisers, October 2017. https://www.whitehouse.gov/sites/whitehouse.gov/files/documents/Tax%20Reform%20and%20Wages.pdf

The Middle Class

The stagnation of the middle-class that the TCJA's wage effects stands poised to partially reverse, however, warrants a multi-pronged policy approach. But the urgency of policies to redress the wrongs inflicted upon the middle-class requires understanding the causes of the middle-class's stagnation in the first place, including the role of government policy itself. As the third chapter in the *Report* lays out in detail, the previous Administration's policies can explain some of the middle-class's stagnation during its tenure.

The inflation-adjusted labor income of the typical household at the middle of the income distribution is still below what it was at the start of the 21st century. And one explanation for this historical slowdown, the Report's analysis shows, is that the Obama Administration's tax and transfer policies worsened the wound through their effect on the labor market. Based on CEA estimations using Census Bureau data, the median American's inflation-adjusted total household income from working took 9 years to recover to its pre-recession level after the Great Recession – the longest this type of recovery has taken since at least 1979.

To be sure, these tax and transfer policies softened the blow of the recession by partially making up for lost income. That was their intended effect. But economics is a science that distinguishes itself by its focus on unintended as well as intended effects. And these same policies had unintended effects: they decreased the incentive to work, contributing to declining labor force participation and thestagnation of wages that reached historic proportions in this recent chapter of American economic history. All in all, then, in spite of the intentions behind them, these policies undermined the well-being of the very middle-class households they were intended to help.

Although much has been written about the retirement of the Baby Boomers as one of the main causes of the reduction in labor force participation, that explanation is only one piece of the puzzle. Demography is not destiny when it comes to economic growth, and the *Report* explains why the Administration believes that reducing work disincentives and rising wages, which we are finally starting to see, will bring people off the sidelines. A combination of policies and economic conditions that return the prime-age (between ages 25 and 54) participation rate to the level in 2007 (still well below the rate apparent in 2000) would return about 1.7 million U.S. workers to the labor force over 10 years and raise the overall participation rate by 0.065 percentage point per year, resulting in a 0.1-percentage-point increase per year in the rate of GDP growth over the next 10 years, according to CEA's estimates.

Related to workforce participation, I would like to add a note about the President's immigration policies, which focus on a merit- or skills-based approach. There has been a discussion about immigration being a headcount exercise. But the economics of human capital tells us that bringing in immigrants who are highly productive and skilled as opposed to those who simply arrive through a family relation and who may have low or no skills shows why a headcount is not the way to think about the impact of immigration on growth. For instance, a predecessor of mine at the Council of Economic Advisers, Edward P. Lazear, has written about the importance of understanding the relationship between the education levels of prospective immigrants and the economic effects their admission could rationally be expected to have.[2] It does not simply boil down to the number of people who arrive on our shores.

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[2] Lazear, Edward. "Why Are Some Immigrant Groups More Successful Than Others?" October 2017. NBER Working Paper No. 23458. http://www.nber.org/papers/w23548

Deregulation

Regulatory reform was central to the Administration's economic agenda in the first year. Just as a backward tax code harms economic growth, overregulation drags down the economy. The Report's chapter on deregulation documents the ways in which regulations stifle productivity and prevent the creation of new businesses. Given the profundity of its effects on economic activity – regulation can determine which businesses have the opportunity to even start in the first place – the extent to which the regulatory environment will shape the set of risks and opportunities facing the U.S. economy in the future is easier to underestimate than it is to overstate.

For instance, regulations give incumbent businesses an advantage against upstart competitors, and an increase in regulation may be one of the reasons business dynamism has suffered a decline since the recession. The year 2009 marked the first time that more firms died than were born in the United States since the Census Bureau began compiling its Business Dynamics Statistics in 1978.[3] And recent research shows that fewer younger Americans are becoming entrepreneurs, an ominous development.[4] Meanwhile, evidence reviewed in the *Report* documents that the start-ups that are most likely to be smothered by pages of regulation tend to make disproportionate contributions to productivity growth.

The tepid growth rates observed under the previous Administration, then, can hardly come as a surprise in light of the evidence reviewed in the *Report*'s chapter on deregulation. Nor can the acceleration in GDP observed under the Trump Administration appear surprising, given the Trump Administration's commitment – and success – in pursuing its regulatory agenda.

Of course, not all regulations are bad, and the type of changes envisioned by this administration will not threaten the environment or worker safety. To put our overregulation into perspective, CEA finds that if the U.S. regulatory environment were such that the U.S. had the same OECD Product Market Regulation value as Germany, we would increase annual growth by 0.1 percent per year. If we deregulate further, to the level of the Netherlands according to the OECD Product Market Regulation index, we could get growth at twice that rate: 0.2 percent per year. In spite of what you may think about the regulatory environments in European countries, even they recognize that liberating the economy from the burdens of regulation can unleash economic activity and create jobs.

Regardless of your view of the magnitude of its effects or your philosophical disposition, it is difficult to dispute that regulation affects economic activity along many margins of adjustment. The footprint of regulation – along with the effects of lightening the regulatory load – manifests across many of the data series economists use to gauge the economy. And the Trump Administration is committed to ensuring that it develops a regulatory environment that creates an economy filled with opportunities realized -- rather than opportunities lost.

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[3] Hathaway, Ian and Robert E. Litan. "Declining Business Dynamism in the United States: A Look at States and Metros." 2014. Brookings Institution. https://www.brookings.edu/wp-content/uploads/2016/06/declining_business_dynamism_hathaway_litan.pdf

[4] Economic Innovation Group. "Millennials & Entrepreneurship." 2016. http://eig.org/wp-content/uploads/2016/09/Millennials-Entrepreneurship.pdf

Infrastructure

This Administration's deregulatory agenda complements its infrastructure agenda, which aims to equip America with the infrastructure it needs to remain competitive in the 21st century and beyond.

Investing in infrastructure via the stimulus and its shovel-ready projects was expected to be a major factor in our recovery to the Great Recession, but – as Chapter 4 of the *Report* shows – this type of investment ended up as only a fraction of what was promised, with only 3.5 percent of the over-$800 billion plan going to highway transportation infrastructure. And at least part of the reason infrastructure did not pan out as hoped was the amount of red tape that stood between the legislation and the infrastructure projects that would benefit America's would benefit from.

Improving infrastructure should have wide bipartisan agreement, and polls show it is highly popular among the American people, with 84 percent in support and 76 percent believing it should be funded as the president has suggested: a combination of public funds, bonds, and public-private partnerships. As the *Report* notes, sources indicate that in 2014 total congestion costs peaked at $160 billion, wasting 6.9 billion hours in delays and 3.1 billion gallons of fuel.

Bureaucracy has built up over decades, creating years-long obstruction on many projects. The President's infrastructure plan focuses on streamlining the permitting process and eliminating red tape that has stymied infrastructure projects from being efficiently developed and managed to enable projects to get off the ground faster. The plan also calls for a $1.5 trillion investment in infrastructure, which we find could add 0.1 to 0.2 percentage points to economic growth over the next decade, saving Americans precious time by alleviating traffic congestion and enabling them to connect to opportunities that create more prosperity.

Our report lays out additional steps such as enacting targeted user fees, facilitating public-private partnerships, and ensuring that infrastructure funding goes towards the most-valuable infrastructure projects. These steps will ensure that this Administration allows America to develop the infrastructure that it will help it remain competitive now and in the future.

Trade

Trade across national boundaries matters in the short-run, but its effects on economic activity become all the more-dramatic in the long-run. This Administration's focus on ensuring that America's trade policies are fair to America's workers, consumers, and businesses is a reflection of its recognition of this reality. And its willingness to devote the resources it has to trade policy is an investment poised to pay dividends in the form of the benefits it will deliver to future generations of Americans.

The trade chapter of *Report* documents that American firms tend to face higher barriers to exporting their products abroad than their peer firms in the group of high-income G20 countries tend to face in exporting their products to the U.S . This holds true when looking at tariffs or non-tariff barriers, which have grown in importance as tariff rates have trended down.

CEA also notes that in recent decades, trade has left some American communities worse off. When you look at the data, it is not hard to see why this Administration is seeking to improve America's position with respect to international trade. Additionally, the global trade system has come under strain due to the influence of countries, such as China, that violate market principles and distort the functioning of global

markets. When America's businesses and workers can compete in the global economy on a level playing field, our underlying dynamism will allow our economy to flourish.

A priority of the Administration is to create the conditions that would maximize the benefits from trade that accrue to the United States—and produce gains for our trading partners as well – both now and in the future.

Health

The importance of few issues studied by economists is as easy to understand as health. The *Report*'s chapter on health examines the status of Americans' health and the options that could allow them to live longer lives and to live healthier lives.

The Administration is focused on policies that would improve healthcare outcomes and lower healthcare costs for all Americans. CEA's analysis calls attention to several factors that affect health and healthcare costs, such as smoking, obesity, and opioid abuse, which have contributed to the decline of American life expectancy for the second year in a row.[5]

CEA highlights how competition and choice could improve health insurance as well as lower American drug prices—without undermining American pharmaceutical innovation. The Federal government can also pursue policies that lead to other countries paying their fair share for innovations. CEA estimates that, among members of the OECD, Americans pay more than 70 percent of patented biopharmaceutical profits that fund drug innovation.

It is tough to think of an issue as fundamental to human wellbeing as health. As explained in the health chapter, this Administration has a framework for understanding how to ensure that Americans can enjoy the high-quality health outcomes they deserve.

Outlook

The 2018 *Report* concludes by examining the year in review and offering our projections for the years ahead.

As CEA's analysis shows, the U.S. economy experienced a strong and notable acceleration in 2017, with growth in real gross domestic product exceeding expectations and increasing to 2.5 percent, up from 1.8 percent during the four quarters of 2016, and the unemployment rate falling 0.6 percentage point to 4.1 percent, the lowest since 2000. The Administration's baseline forecast for the longer term is for output to grow by an overall average annual rate of 2.2 percent through 2028, excluding the effects of the December 2017 Tax Cuts and Jobs Act.

The policy-inclusive forecast, which assumes implementation of the Administration's agenda —tax reform, deregulation, infrastructure and addressing disincentives to work—is for real GDP to grow by 3.0 percent a year, on average, through 2028. The current Administration's long-run, policy-inclusive forecast is conservative relative to previous administrations, and is in fact slightly below their median of 3.1 percent. The implementation of the Administration's full policy agenda – on taxes, deregulation, and

[5] "Mortality in the United States, 2016." December 2017. National Center for Health Statistics Data Brief No. 293, Center for Disease Control." https://www.cdc.gov/nchs/data/databriefs/db293.pdf

infrastructure – would allow growth to reach these rates. Meanwhile, the Administration's baseline forecast for the path of growth in the absence of policy changes is exactly in line with the long-run outlook given in the Obama administration's last *Economic Report of the President* (2017). While failure to implement the Administration's priorities would allow the tepid American growth observed in the Obama years to continue, the implementation of the Administration's agenda on infrastructure and deregulation as well as taxes would allow growth to reach the path set out in the policy-inclusive forecast.

Conclusion

As the size of the 2018 *Report* attests, it is no easy matter to "gather timely and authoritative information concerning economic developments and economic trends, both current and prospective," as the Council is required to do under the Employment Act of 1946. To attempt to do so is to undertake a task that imparts both a sense of exhilaration and of humility.

If fully implemented, as the *Report* explains, the Administration's agenda on taxes, infrastructure, and deregulation stands poised to offer an escape from the "new normal" of low economic growth that became a norm only in the last decade. With the right policies, this Administration can do its best to ensure that the future is one of opportunity – and expectations raised – rather than one of expectations lowered. With growth forecasts climbing up under the Trump Administration, there are already signs that Administration's policies have tipped the economy in this direction.

But there is much work still to be done. And as Chairman of the Council of Economic Advisers, I am proud to have presided over the production of a *Report* that explains how policymakers can do their part to deliver a robust and vibrant economy replete with opportunity, both now and in the future.