

Prepared Testimony before the Joint Economic Committee
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Chairman Brady, Vice Chair Klobuchar, and Members of the Committee—thank you for the chance to appear before you today. In my statement, I would like to highlight some of the main opportunities and challenges the economy faces right now and then briefly discuss several policies that could capitalize on the opportunities and address the challenges. Of course, the most immediate priority heading into next year is to “do no harm” by continuing to fund the government and pay the bills, but the important affirmative agenda to support growth, job creation, and higher wages remains critical as well.

The Current State of the Economy

I would like to first say a word about the major turnaround we have seen over the last five years. Recently we marked the fifth anniversary of the collapse of Lehman Brothers, an event that touched off one of the most acute periods of economic turmoil in our nation’s history. The crisis manifested itself in a number of pernicious ways, including the loss of more than 700,000 jobs per month in late 2008 and early 2009, and the destruction of \$16 trillion of household wealth.

Five years later, a resilient private sector has added 7.8 million jobs over 44 consecutive months. Job growth has been steady, with 2.4 million jobs added in the last twelve months, 2.2 million jobs in the twelve months before that, and 2.2 million jobs in the twelve months before that (Figure 1). Since early 2010, we have seen over half a million jobs added in manufacturing, and more than 400,000 added in the high-tech industries (outside of manufacturing) which employ the largest share of scientists, engineers and technicians. The unemployment rate has fallen by about seven-tenths of a percentage point per year, and while it remains unacceptably high at 7.3 percent, it is now back to where it was in December 2008. The economy has expanded for sixteen out of the last seventeen quarters, America has a strong auto industry, our banks are increasingly well-capitalized, our housing prices are rising and construction is recovering.

The most recent data indicate that the economy was strengthening through the third quarter, with GDP growing at a 2.8 percent annual rate and job growth revised up for August and September to an average of 200,000 jobs per month. The data for October are consistent with an economy with a private sector that continues to drive the recovery, with strong payroll job growth continuing into October, although this growth likely would have been even stronger were it not for the shutdown and the brinksmanship over the debt limit. The negative consequences of these episodes on the economy can be seen in a range of data, especially for the first weeks of October, when unemployment insurance claims spiked, chain store sales slowed, worker-reported instances of hiring decreased, and consumer confidence plummeted. Although there were significant shutdown-related measurement issues in the household survey for October, it also showed signs that the shutdown negatively impacted the economy.

Areas of opportunity

With this context, there are five areas of opportunity that I would like to highlight, including two cyclical factors that could contribute to the recovery, and three structural factors that have significant potential for longer-run growth, job creation, and wage increases.

Cyclical Factors that Could Contribute to the Recovery

First, the most immediate macroeconomic opportunity is the remaining potential for continued strong increases in residential investment, consumer durables (including autos), and consumer spending more generally. Residential investment has helped drive the recovery over the last two and a half years, growing at a 12 percent annual rate, and significant potential remains for growth in this area. As discussed in the 2013 *Economic Report of the President*, the over-building of new homes during the bubble years was fully offset by several years of depressed construction activity. Consequently, new residential construction is now poised to rise to a level more consistent with historical rates of new household formation and property depreciation (Figure 2). These fundamentals imply that we will eventually return to a level of residential construction activity substantially above the roughly 900,000-units-per-year pace we have seen in recent months.

In addition, we have seen strong motor vehicle sales, with the third quarter selling rate the highest in over five years (Figure 3). Here too is potential for further growth given that the average age of cars on the road recently reached a record high of 11.4 years. While some of the increased longevity of cars can be attributed to improved vehicle quality, it is also likely it partially reflects deferred car purchases that will be recovered over the next few years.

Moreover, consumer spending in general has the potential to grow as employment gains boost incomes, access to credit improves, and household balance sheets continue to strengthen. We also saw the two main measures of consumer sentiment reach multi-year highs over the summer, although they both fell back sharply in October in response to the shutdown and debt limit brinksmanship.

Second, the economy is headed towards a less contractionary fiscal stance, which should create less of a headwind for private-sector growth going forward—although the magnitude will depend on policy choices like the resolution of the sequester. The budget deficit has fallen rapidly, from 9.8 percent of GDP in fiscal year 2009 to 4.1 percent of GDP in the fiscal year that just concluded. That is the fastest sustained pace of deficit reduction we have seen in this country other than the demobilization from World War II, and remarkably, nearly half of that total deficit reduction—2.7 percent of GDP—took place in just one year: fiscal year 2013.

Although deficit reduction is an important long-term policy goal, the rapid fiscal consolidation we have seen over the past year can also create challenges for growth and job creation. Fortunately, we have had a private sector that was leading the economic recovery and keeping our overall growth rate roughly steady, while declining federal spending subtracted from GDP growth in 10 of the last 12 quarters. More broadly, in the last three years we have seen private components of GDP increase at a 3.1 percent annual rate, while the government component has

contracted at a 2.2 percent annual rate (reflecting contributions from both Federal and State and local spending reductions), with a weighted average netting out to a 2.1 percent annual increase in GDP overall.

The good news is that the economy has already gone through the most severe fiscal headwinds at both the federal and State and local levels and that further immediate deficit reduction will be at a more gradual pace. The degree of that pace depends on policy choices, a topic I will return to at the end of my testimony.

Structural Factors that Could Help Longer-Run Growth

In addition to the potential for the immediate recovery, there are three important structural factors that are helping growth today and have the potential to help on a sustained basis in the future as well.

First, the marked slowdown in the growth of health care costs presents both a short-run and long-run opportunity for job and wage growth. Just last month, new data and official projections from the Centers for Medicare and Medicaid Services (CMS) indicated that inflation-adjusted health spending has grown at a 2 percent annual rate over the three years since 2010, the lowest rate recorded since we began keeping track of these data in the 1960s (Figure 4).

The CMS figures show that the slowdown in costs affects all portions of the health sector. Over the three record-setting years from 2010 to 2013, inflation-adjusted per-beneficiary spending by private insurers is projected to have grown by just 1.6 percent per year. The comparable figures for major public health insurance programs are even lower: 0 percent for Medicare and -0.5 percent for Medicaid. All of these rates are well below the average annual growth rate of inflation-adjusted per capita health spending over the decade ending in 2010 (3.2 percent). Moreover, the slowdown has affected virtually all categories of spending. Over this period, there have been particularly large reductions for prescription drugs, with spending actually falling in real terms.

The CMS announcement followed an August release from the Kaiser Family Foundation, which reported estimates of average health insurance premiums from its annual survey of employers. Kaiser found that premiums for employer-provided family coverage grew just 2.3 percent from 2012 to 2013, after adjusting for inflation, less than one-third the rate observed in the early 2000s.

The Congressional Budget Office (CBO) and a wide range of analysts have concluded that only a small fraction of the current slowdown can be attributed to the recession as evidenced by the facts that you see the slowdown in areas like Medicare, and the health care component of the personal consumption expenditures price index, both of which are less subject to cyclically-driven fluctuations. Much of the slowdown appears to reflect deeper changes affecting the health sector and has the potential to be persistent. It is also likely that some of the features of the Affordable Care Act that have already been implemented, such as payment reforms that incentivize better patient outcomes, are contributing to the slowdown in cost growth.

In the long run, savings from slower health care cost growth will be passed on to families in the form of higher wages. But in the short and medium run some of these savings are reflected in lower pressure on employee compensation, which in turn means more job growth.

Second, the dramatic increase in domestic energy production is another opportunity for the U.S. economy—and also for our security and climate. Government-funded research supplemented private industry’s work to develop the technology that sparked the boom in oil and gas production. Crude oil production has grown each year the President has been in office to its highest level in 17 years in 2012. In fact, over the past four years, American domestic oil supply growth has accounted for over one-third of global oil supply growth. Natural gas production increased by 5 percent in 2012 and currently is at an all-time high. Stronger fuel efficiency standards and investments in cutting edge technologies have led to the most fuel efficient light-duty vehicle fleet ever, and we are working to increase the efficiency of the medium- and heavy-duty fleet as well. At the same time, we have almost doubled the production of biofuels since 2007 to a near all-time high, which further reduces our need for oil in the transportation sector. The result of these advances is that United States is now nearing the point where our domestic production of crude oil exceeds our net imports of oil on a sustained basis (Figure 5).

Even as we continue to see positive signs in the area of domestic oil and gas production, the President remains firmly committed to an “all of the above” energy strategy, and there have also been great strides made in expanding the use of renewable sources, which in total have grown by over 20 percent since the beginning of the Administration. Wind and solar production have each more than doubled since the President took office, and Congress made sure this progress would not be derailed when it included an extension of the Production Tax Credit in the American Taxpayer Relief Act signed earlier this year. The creation of an Energy Security Trust Fund – which the President proposed in his last State of the Union – would represent an additional commitment to the investments in renewables that will be needed to broaden adoption of these important sources.

Ultimately, the broad-based energy boom we have seen has a number of advantages for America, including contributing directly to jobs in the energy sector, and indirectly to jobs in other sectors by making energy-intensive industries, like manufacturing, more likely to locate and succeed in the United States. Increasing productivity through new techniques and technologies raises national income and increases growth. Reducing America’s dependence on foreign oil and increasing our net exports leads to greater energy security, higher economic growth and higher standards of living. Finally, our shift towards renewables and natural gas has improved the climate outlook.

Third, technology provides significant opportunities for long-term growth, especially in areas that benefit from the combination of mobile computing and increasingly fast wired and wireless Internet connections. Total factor productivity, which measures our ability to produce more output from a given set of inputs, has grown at a 0.8 percent annual rate in the last forty years since 1973, which is well below the 2.2 percent annual growth rate enjoyed in the golden age from 1948 to 1973. Even small improvements in Total Factor Productivity growth going forward would make a profound difference over time.

One of the promising areas for Total Factor Productivity growth is the innovations in hardware and software for mobile devices and the wired and wireless infrastructure investments to support these technologies. In the last four years annual investment in U.S. wireless networks grew more than 40 percent, from \$21 billion to \$30 billion. At the same time, investment in European wireless networks remained flat and wireless investment in Asia (including China) rose only 4 percent. This infrastructure is at the center of a vibrant ecosystem that includes smartphone design, mobile app development, and the spillovers from the widespread adoption of these technologies in our communities.

Outstanding Challenges

While we have made substantial progress and have significant potential for further progress, more work remains to be done in helping our economy recover from the 2007-09 recession and address much longer-term trends and challenges. I want to highlight three important challenges:

First, we are still struggling with the major legacy of the severe recession—significant elevation in the unemployment rate and a reduction in the participation rate, which are creating hardship for millions of families. The current elevation in the unemployment rate is primarily due to the large number of long-term unemployed workers (Figure 6). If one looks at the unemployment rate based only on persons out of work for less than 27 weeks, this measure is largely back to its pre-recession average. The bulk of the remaining elevation in the unemployment rate is due to the fraction of the labor force that has been out of work for 27 weeks or more, which remains 1.6 percentage points above its pre-recession average. This aspect of the current labor market situation is an important reminder that despite the progress we have seen, more work must be done to boost aggregate demand, support job creation, and provide a path back to employment through our employment services. These steps are especially urgent because the longer the situation persists, the harder it becomes to address the erosion of skills that can result from a period of extended unemployment.

At the same time, the participation rate has continued to fall. One important reason for this fall is demographic shifts arising from the retirement of the baby boom generation, a trend that has been long anticipated. In 2004, for example, the *Economic Report of the President* noted “the long-term trend of rising participation appears to have come to an end. ... The decline [in the labor force participation rate] may be greater, however, after 2008, which is the year the first baby boomers (those born in 1946) reach the early-retirement age of 62.” The economic downturn further contributed to a cyclical reduction in the participation rate, possibly exacerbated by the increase in the long-term unemployment rate. The demographic trend towards lower participation rates will continue but the cyclical contribution to lower participation rates should diminish as the economy continues to heal.

The second and less widely appreciated challenge is that the recession appears to have exacerbated a longer-term trend of reduced job-to-job mobility for the labor force. We have all had our eye primarily on improving net job growth—the additional jobs added each month. However, the flow of workers across firms—hiring in excess of job creation and separations in

excess of job destruction—plays an important role in the U.S. labor market. This job switching improves the allocation of workers to jobs and supports wage growth as workers switch to new, higher-paying jobs. Job switching also helps workers find the jobs for which their skills are best suited, which can increase their productivity and fuel more robust economic growth. Academic economists and those in the Federal Reserve System have documented a large decline in worker mobility over the past several decades, with declines concentrated in the recessions of 2001 and 2007-2009. Job openings, voluntary separations, and total hires declined substantially during the recession and have only partially recovered. The quit rate also remains below pre-recession levels, as workers are likely still reluctant to voluntarily leave jobs. While the sources of this declining mobility are at least partly cyclical, other structural sources are not fully understood, and it is an important indicator for us to watch.

Third and finally, the longest standing and most deeply embedded challenge we face is the rise in inequality. We have seen a large increase in inequality since the late 1970s, arising from a combination of technological change, globalization and institutional changes, like the erosion of the inflation-adjusted minimum wage and the decline in union membership. The first two of these changes have tended to raise the relative demand for capital and skilled labor and therefore the returns to these inputs. At the same time deceleration in educational attainment, suggests a possible growing scarcity in skills and therefore the number of workers poised to take advantage of the increased demand and wages available to skilled workers. And the weakening of long-accepted labor market institutions further lowers the status and power of the workers left behind and therefore their earnings.

These deeply rooted trends have continued over the course of this recovery and manifest themselves in both earnings data and income data. The income data through administrative tax records provides a particularly clear window into the very top of the income distribution. These data, as compiled by Emanuel Saez of the University of California at Berkeley, show that the top 1 percent of tax units received 19.3 percent of total income (excluding income from capital gains, which can be highly volatile year-to-year) in 2012 (Figure 7). This was the largest share since 1928 and up from 17.5 percent in 2011. About half of the increase in the top 1 percent income share went to the top 1 percent of the top 1 percent—the 0.01 percent. This is all symptomatic of a broader trend of the disconnect between productivity growth and compensation for the typical middle-class family. Addressing inequality and reconnecting productivity growth and wage growth for typical families are both part of the same challenge.

The Policy Agenda

The most immediate priority is to do no harm by avoiding repeated fiscal wrangling and another government shutdown, allowing our economy to capitalize on all of the opportunities I sketched earlier, notably housing construction, reduced fiscal headwinds, health cost containment, the energy boom, and technological advances. Beyond that, however, there are substantial opportunities to build on the favorable trends I identified while making more rapid progress in addressing the challenges through an affirmative agenda to create jobs, increase growth and raise wages. I will focus on two specific areas—budget policy and the broader agenda to create what the President has called “a better bargain for the middle class.” In addition to these areas, the

President has also identified immigration reform and the farm bill as two economically important proposals that have been passed by the Senate and should be enacted by Congress.

Budget Policy

The President's Budget proposes investments in jobs and growth, a replacement of the sequester, entitlement reform particularly continued efforts to slow the growth of healthcare, and tax reform particularly in the area of business taxation. The proposal includes significantly more medium- and long-run deficit reduction than the sequester: in 2021, the President's framework has \$224 billion in non-interest deficit reduction as compared with \$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 2.1 percent of GDP in 2023 under the President's approach, consistent with falling debt as a share of GDP (Figure 8). Moreover the President's proposal shifts the composition of spending towards investments in infrastructure and research, while continuing to take steps to strengthen Medicare by reducing overall health spending and reforming the tax code to reduce inefficient tax expenditures. The President is encouraged that the conference committee is working on reconciling the House and Senate budgets through a regular order process and is encouraging the committee to follow this type of balanced, growth-oriented approach to investing in priorities and reducing the medium- and long-run deficit.

The Better Bargain for the Middle Class

Getting beyond these immediate fiscal challenges would help allow the U.S. economy to continue to mend and strengthen. But there are opportunities to do substantially more to support job growth and to continue to push back against the deeper trends of inequality. For instance, CBO and other economists estimate that we can increase GDP growth, raise long-run productivity growth, raise long-run wages, and reduce the budget deficit by simply passing commonsense immigration reform. Other opportunities to do more include the elements of a "Better Bargain for the Middle Class" that the President has been laying out such as:

- **Jobs.** The President has called for a Grand Bargain on Jobs that would include business tax reform to broaden the base, reform the structure, and cut the rate, combined with investments in infrastructure, manufacturing and training. At the same time, to help turn the slowdown in foreign economic growth from a challenge to an opportunity, the Administration continues to work towards new free trade agreements like the T-TIP and TPP that will facilitate mutual gains from trade, create new market access for American products abroad, and set high standards for intellectual property, labor and environmental issues, helping to create more good, higher paying jobs in the United States.
- **Housing.** Over the summer, the President laid out his vision for housing finance reform, which would replace Fannie Mae and Freddie Mac with a system based around private capital, safe and responsible mortgage products, and an explicit and very narrowly defined role for government. The Administration is supportive of bipartisan efforts in the Senate to make this vision a reality and create a more stable foundation for affordable homeownership.

- **Retirement.** A number of studies have found that the current architecture and tax incentives for retirement savings could be greatly improved, especially as they relate to low- and middle-income households. The President's Budget proposals have repeatedly set out ideas for creating a better retirement saving system, including automatic IRA enrollment and an expanded tax credit for small employers starting new 401(k)s. We have known for years that too many households are unable to accumulate sufficient savings for a secure retirement, and the financial crisis no doubt exacerbated the problem. This area is critically important for middle class security and is ripe for improvement.
- **Health Care.** Earlier I mentioned the substantial slowdown in health care costs that we have witnessed recently, but the next step is making sure that all families have the chance to take advantage of it. Unfortunately, too many Americans have had difficulties with the online insurance marketplaces. The Administration continues to work around the clock to address technical issues and create a better shopping experience for consumers, which will ultimately allow the Affordable Care Act live up to its promise.
- **Ladders of Opportunity.** Central to the President's agenda are policies that can foster greater economic mobility across generations and give all citizens a path to the middle class. In particular, the President is focused on expanding access to early childhood education and making college tuition more affordable, two priorities that are essential to making sure that children have the chance to realize their full potential. To make sure that work pays, the President is also calling for an increase in the minimum wage that would ensure that a parent working full time would not have to raise his or her children in poverty.

I look forward to answering your questions.