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JUMPSTARTING THE ECONOMY

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BEFORE THE

SUBCOMMITTEE ON ECONOMIC POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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ON

INCREASING THE INVESTMENT IN THE EQUITY MARKET AND
IN RURAL AMERICA

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C O N T E N T S

THURSDAY, MAY 22, 2003

WEDNESDAY, JUNE 25, 2003

JUMPSTARTING THE ECONOMY: INCREASING INVESTMENT IN THE EQUITY MARKETS

THURSDAY, MAY 22, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON ECONOMIC POLICY,
Washington, DC.

The Subcommittee met at 10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Jim Bunning (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. I would like to call the first hearing of the Economic Policy Subcommittee of the 108th Congress to order.

I want to thank all of our witnesses for being here to testify.

Today, we have the first in a series of hearings titled, "Jumpstarting the Economy." I do not think that it could be more appropriately timed, since we are about to embark on a very interesting 2 days as far as the tax bill is concerned. I am very concerned with the state of our economy. I am very worried about the possibility of a double-dip recession. I know that that puts me at odds with more optimistic experts like Chairman Greenspan, but we have disagreed before. We are not growing like we can and we are not creating jobs—particularly not creating jobs. There are many reasons for this.

I believe Chairman Greenspan acted way too slow to cut rates back in early 2001. He should have cut them in the fall of 2000. The corporate governance scandals have hurt trust in the markets. Sarbanes-Oxley and other actions have helped, but it will take a long time for corporate America to rebuild that trust. September 11 had a devastating effect on our economy. The two wars that we have had since then also have not helped.

The reason why most of these events have been so harmful to this economy is because they have created uncertainty in our markets. If there is one thing that shakes the markets, it is uncertainty. I am hopeful that our witnesses today will help us find a way to bring some certainty back to the markets.

Since the height of the bull market in March 2000, the stock market's values have been reduced by about $8.5 trillion. At the market's height back in early 2000, the market cap of the Wilshire 5000 totaled $17 trillion. By the time of the market's low in early October, the index's market cap had shrunk by about half of that amount, or about $8.5 trillion. We have a $10 trillion economy right now. We have had stock losses of $8.5 trillion in 3 years. It is not surprising that investors are skittish.

If we are going to grow this economy, we have to get the people investing again. We need to create capital so businesses have the opportunity to invest and grow. Before we adjourn for Memorial Day, we will be voting on a growth package. I think it is critical that we send a package to the President for his signature.

I wish the package was bigger, much, much bigger, I hope $350 billion is enough to move a $10 trillion economy, but we must make a start somewhere. We must create jobs and we must make sure that our economy grows. We must bring back some certainty to the markets if we are ever going to grow this economy and prevent a double-dip recession.

Once again, I thank all of our witnesses for testifying today. And since my colleagues are at other meetings right now, I am going to start with Mr. Fisher from the Department of the Treasury as our first witness.

The mic is yours, Mr. Fisher.

STATEMENT OF PETER R. FISHER
UNDER SECRETARY FOR DOMESTIC FINANCE
OFFICE OF PUBLIC AFFAIRS
U.S. DEPARTMENT OF THE TREASURY

Mr. FISHER. Thank you, Mr. Chairman.

I am very pleased that you have chosen to hold this hearing on the challenge of increasing the incentives for investment. If you will permit my written statement to be included in the record, I would like to briefly summarize my remarks.

Senator BUNNING. Without objection.

Mr. FISHER. Thank you.

To reinvigorate our Nation's economy in this decade, and to pay for our collective retirement in the coming decades, we need to enhance the incentives for investment that will create the jobs we need now and to sustain our standard of living in the future. To do this, both the public sector and the private sector must do their part.

We in the Federal Government must examine and remove the legal and regulatory obstacles to greater savings and investment. In the private sector, to rebuild investor confidence, as you pointed out, Mr. Chairman, I believe that publicly traded companies need to do a better job of disclosing information to their shareholders.

We are not satisfied with the current rate of job creation in our economy. In order to do something about this, we need to increase investment. There is only one place that new jobs come from—they come from the willingness of investors and entrepreneurs to put capital at risk in a business venture. The President has focused us precisely on this point, on sharpening the incentives for productive investment by reducing the biases against equity investment that now exist in our tax code.

There is no better example of these distortions that discourage savings and investment than the current double taxation of corporate dividends. No one defends the double taxation of dividends from first principles, and no other major industrial nation taxes profits at such a punitive effective rate. We are encouraged by the progress now being made on the President's jobs and growth proposal, including progress toward lowering tax barriers to savings and investment.

The Administration, as you alluded to, Mr. Chairman, is working closely with Congress today, yesterday, and over these next few days, to obtain the best package possible as quickly as possible. The President has made clear that the sooner we get this done, the sooner we will be creating the jobs that put people back to work.

Increasing the incentives for savings and investment in America will require effort not only, or even principally, by the Government, but also by the private sector. In particular, it will require a sustained effort by corporate leaders to restore investor confidence.

Congress passed the Sarbanes-Oxley Act, and the SEC and the Justice Department are successfully implementing its provisions to improve corporate governance. But publicly traded companies also have a responsibility to restore investor confidence by providing shareholders with better, more useful information about the companies in which they invest.

Our Nation's securities markets are extremely efficient at pricing and allocating capital on the basis of all available information. Unfortunately, important information about the real economic leverage of the firm and about the firm's current condition and business prospects is too often not available.

To restore investor confidence, shareholders need to be able to see the companies that they own through the eyes of management. Private-sector leaders should take the responsibility to transform the practice of corporate disclosure, to set new standards of best practices that will genuinely inform investors about their firm's risk/reward prospects. Until they do, I fear that investor confidence will not be restored to the point where we will see the increased equity investment that our economy needs.

But if we in the Federal Government can strive to reduce the obstacles to savings and investment imposed by our tax code, and if corporate leaders strive to give shareholders more useful information about the companies in which they invest, then we are much more likely to see the expansion of equity investment that is necessary for our future prosperity.

Thank you for this opportunity to be here and I look forward to your questions, Mr. Chairman.

Senator BUNNING. Thank you very much, Mr. Fisher.

Let me start out by talking about the current bill that we have, or proposed bill that we have before us in the stimulus package, or the job-creation package, whatever you want to call it. It is the tax bill. What do you believe would happen if we did not—I say not—pass the stimulus package?

Mr. FISHER. Well, when I look out at the economy, as you described it, I see a need for us to do two things to get the economy moving at a pace that will create jobs. We need to have balanced support for both consumption and investment. The package the President proposed, and still the variables now being debated these last few days do provide us balanced support—doing something for homeowners and families and hard-working Americans, and doing something to give business incentives for greater investment.

Particularly the latter. We see that over the last few years, we have a lack of business investment. As both you and I have pointed out, business investment is the key to new jobs.

Therefore when I look at the risks to our economy now of underperforming its potential, then we will run a much higher risk of the double-dip inflation that you are concerned about. Or if not a double-dip, then lower growth than needed to create the necessary jobs. We simply do not need to take that risk. We should be doing something to provide balanced support.

Senator BUNNING. There are many ways to put 51 votes together to get a package passed. One of the unique ways that is in this bill, at least it was as of last night, and I suspect that it was this morning when the President appeared up here, is a $20 billion allotment for States.

Now, we all know that State governments are having the same problem as the Federal Government. I know that a $8 billion shortfall is occurring presently in California. In Kentucky, it is not as large, but it is proportionately as large. And many other States are. I think there is only one State that does not have a budget deficit. It seems to me that, on the policy side of tax, that this is a horrible idea. I just would like your opinion on the Federal Government investing $20 billion in the shortfalls of State governments.

Mr. FISHER. Well, I am aware of the proposals now circulating. I haven't had a chance to study the bill language that you may have been up late last night with.

Let me be clear. Direct support for the States was not part of the President's proposals, going back to January. We felt the best thing to do for State governments was to try to get the economy going.

I do not remember the exact figures now, but for every 1 percent increase in GDP in the country, States experience a greater than 1 percent increase in sales tax revenues.

It seemed to us that the more we focused on the combined problem of job creation and revenue shortfalls, that the best way to address both problems was to get investment moving and try to get the economy moving. So that was certainly our first choice going back to the President's proposals.

Senator BUNNING. Okay. You stressed in your testimony the need to reduce market distortions that discourage savings and investment and the need to increase transparency. Do you really think that the same measures will bring benefits in both the short- and long-term?

Mr. FISHER. Yes, I do. I think that the real way to restore investor confidence and business leader confidence is to give them the kind of planning horizons that they need to make investments now. That is, confidence to make an investment today comes from being able to see far enough into the future, that you can make plans and have confidence.

So to give our economy a boost today in the form of investment and, frankly, also to give American families confidence in their financial position for the future so that they can make consumption decisions today, you will get the effect in both places if you provide sound tax policies.

And so, on the rate front, as I have said many times, just as homeowners experience an enduring improvement in their household cashflows when they refinance their mortgages at lower rates, and they get to see that they are going to have that income there month after month and quarter after quarter, they then feel more confident about their future and may feel better about buying large durable goods—a new refrigerator or a new car.

Now for business men and women, it is the same issue. To make an investment now, they need to see that investment horizon, lowering the burden on investment, lowering the tax burden, in order to make that investment so that they can see the return.

I think that when we do sound tax policies that have an enduring impact, we will get the benefit now of the investment that we have been lacking, and that very investment is what will sustain us into the future.

Senator BUNNING. Let's go back to the tax bill, then, because I am not a policy work, but I would like sound tax policy.

We are creating a bill that adds more confusion and more pages to the current tax code. It certainly is not simplification. We are doing investment tax credit for 1 year at 50 percent. We are doing expensing 1 year at $100,000, it is my understanding. We are doing the child tax credit for 2 years. We are doing the marriage penalty correction for 2 years. That seems to me to be a horrible tax policy. You are talking about having the knowledge and the ability to look into the future and that business and investors like to be sure of what is going to be there. In 2 years, some of these things are not going to be there. In some cases, they are not going to be here after 1 year.

So, as far as policy is concerned, we have created something that will pass with 51 votes. My opinion is that it will stimulate for a short period of time.

The dividend is not the exact dividend policy that the President has brought forward, but it is the House version where we reduce capital gains on dividend income from the current rate, which would be 35 or whatever bracket that you are in, to apply a capital gain rate to it at 15 percent. If you are in the 10 percent bracket, it is reduced to 5 percent. And that stays in for quite a while.

What we are doing is taking dividend taxation and not double-taxing it, but taxing it at a capital gains rate. You are looking at tax policy and that is your job. What kind of tax policy is that?

Mr. FISHER. Well, as I said, the President's first preferences were in the proposal in January.

Senator BUNNING. I understand that.

Mr. FISHER. And we prefer enduring, and enduring would be even better than what we may have on the table in front of us. However, I think we understand that sunset provisions are not uncommon in all forms of legislation so that Congress can take another look. I think it would be better to have enduring, but we are trying to get the best package that we can.

Senator BUNNING. The restrictions of $350 billion is pretty restrictive and pretty infinitesimal in a $10-plus trillion economy. Or if you look at the big picture of a 10-year picture, where you have a $100 trillion plus economy and you are looking at $350 billion, you must front-load—thank God for our Budget Act, where we allow about $190 billion to be in the first 2 years.

But it is really difficult for me to swallow the way that we sunset because the planners, the policy planners, the people who do the planning for corporate America, that do the planning for individual accounts, have difficulty with the short-term effect of what this tax bill will bring.

I just hope that it is stimulative enough to keep us on the upswing and we do get the capital necessary, particularly for the small business person because about 65 to 70 percent of all new jobs are created by small business, not the giant corporations.

I will ask you one more question and let you be on your way.

As you know, the 1-year anniversary of Sarbanes-Oxley is coming up. I know that Chairman Shelby of the full Banking Committee is planning an oversight hearing to mark the anniversary. Do you believe anything else is needed to be done in the area of corporate disclosure? Is there anything that you think we need to be watching as the SEC continues to implement that law?

Mr. FISHER. Yes, let me make two observations.

First, I think that I cannot now identify any additional actions that Congress should be taking. I am not aware of any. I think that we want to see the implementation of Sarbanes-Oxley work its way through the corporate system going forward. However, I think there is an area we should be sensitive to and try to observe over the next year or so, which is the impact of the additional requirements to improve corporate governance, corporate disclosure, on small companies coming to our capital markets.

That is a sensitive area that we should look at and observe. I do not think that we have enough data now to draw conclusions. But I think over the coming year or so, we should be sensitive to the question of whether small companies, emerging companies, can reach into our deep capital markets and become public companies and raise capital efficiently that way, or whether the requirements we have put in may be an obstacle.

Clearly, given the weakness of the economy and the investment climate, I think the current data on new public offerings by small companies is something that we should not view as a consequence of Sarbanes-Oxley. But this is an area that I think we have to be concerned with going forward.

I would also say that I think there is a great deal that corporate leaders can do and should do to improve the clarity of their disclosures to investors.

I think the SEC is working diligently in implementing Sarbanes-Oxley. It has very good rules out on off-balance sheet disclosure. I know that FASB is working on these issues. But I still think that there is a good deal more that corporate leaders can do to improve the clarity of their disclosures with respect to off-balance sheet leverage and the clarity of disclosure with respect to their business prospects.

I am very concerned looking back over the last decade that corporate leaders now have access to much better information internally, as a consequence of the data management revolution and what computers have been able to do for them in managing data.

So, they have a much better sense of not so much the financial issues, but just their business prospects—new order flow, customer orders. That information is available to them in a way it was not available a decade ago. And that compounds the information, a symmetry on insiders versus outsiders. I think there are a number of businesses and a number of academics who are trying to lead the way to what is called the value reporting revolution, the business value—not so much the financial indicators, but business value disclosure to shareholders about the prospects of the business.

I think there is a lot of room for corporate leaders to do a better job in the MDNA section of their disclosures to get that information out to shareholders. And that is another area that I think we should be watching over the coming years.

But I think that is a terrific question you asked.

Senator BUNNING. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Yes, thank you. I want to apologize to you, Mr. Chairman, and to the witness and the other witnesses. Unfortunately, we have a simultaneous hearing in Judiciary where I am offering, along with Senator Grassley, the amendment on cameras in the courtroom. So, I am going to have to scuttle on down there. But I thank you, Mr. Chairman, for having this hearing.

Thank you, Mr. Fisher, for your terrific service.

First, I would like to just tell you that I think it was great that you were considering a position at the New York Fed. I guess you are not going to take that. I do not know. But if you are, we are going to miss you. Do you want to comment on where you are going, what you are doing, and all that?

Mr. FISHER. No. No, thank you.

Senator SCHUMER. No? I did not think so.

[Laughter.]

But you have done a great job.

Mr. FISHER. Thank you very much.

Senator SCHUMER. If you are staying, continue to do a great job. If you are leaving, you have done a great job.

[Laughter.]

Mr. FISHER. Thank you very much, Senator.

Senator SCHUMER. The question I really wanted to focus on just a little bit is Secretary Snow's comments on the dollar, which have caused a whole lot of controversy and comment.

The Wall Street Journal editorial—well, they were pretty negative. They said: "But the huge danger in bashing the dollar comes from the currency markets themselves. Famous for overreacting, the dollar could fall too fast and too far. Foreign investors hold almost half of U.S. bonds, a third of U.S. corporate bonds, 10 percent of U.S. stocks. Their confidence in the U.S. dollar is not helped if they think the Treasury Secretary is trashing the value of what they own in order to squeeze out more export growth." And I am skipping a sentence or two. "A dramatic sell-off in the dollar would force up interest rates, trounce the stock market, slowing economic growth even further. Someone in the White House should tell Mr. Snow that he is playing with fire."

Could you clarify the Treasury's position on the dollar? Are we abandoning a commitment to the strong dollar, being a strong currency, not one that people happen to like?

Do you agree with the *Journal* that this is a dangerous position that could trounce the stock market? The worry here is not that Secretary Snow or the Administration or the Treasury would force the dollar to go down, but given the precariousness of it all, given that bond trading is now—Euros are an alternative currency, which we have had no alternative currency I guess since Bretton Woods. That even comments to that effect could cause the markets, as the *Journal* says, to push the dollar down.

So that is my first question.

Then, second, once it starts going down, many experts I have talked to say it could keep sliding down and there is nothing that we could do to stop it. Could you comment in general on this?

Mr. FISHER. Senator, I think that I would rather talk about my future career.

[Laughter.]

Senator SCHUMER. Take your pick.

[Laughter.]

The pit and the pendulum.

[Laughter.]

Mr. FISHER. Senator, we have a policy of having the Secretary of the Treasury be the spokesman on the dollar.

Let me be clear—I do not agree with the editorial you read me. I think it is really prudent and in our Nation's best interest to have one spokesman on the exchange rate.

I have a great deal of experience in this area going back to my previous employment, and in the 1990's, on a bipartisan basis, I think we learned that having more than one spokesman on the exchange rate makes things worse, not better. I think that the best course here is to let us have one spokesman on the exchange rate.

Senator SCHUMER. Let me ask you just a general question based on your knowledge and experience. Many people believe what Secretary Snow says. You have substantial input which I believe and I hope is correct. Is there a danger that if something, whether it be the Secretary's comments or anything else in the world, starts causing the dollar to slide, that that slide could become a cascade and could be unstoppable? Do we worry about that in Treasury before making remarks about the dollar?

Mr. FISHER. We are always thinking about the market impact that our comments may have. And sometimes we correctly anticipate—I will speak for myself—what those remarks will be, vis-à-vis bond markets, for example, and sometimes we do not. But we are certainly always trying to anticipate the impact that our utterances can have.

I also think, going back over the last several Administrations, we have learned that the less verbal intervention we have in markets of all types—bonds, stock, exchange—the better we are.

Senator SCHUMER. Well, that would seem to—I do not mean to be persnickety here—that a little bit undercuts what the Secretary said the other day because his remarks clearly caused some change in the temperature.

You know that. We all know that, and that was foreseeable. Now maybe it was positive, maybe it was negative. These issues are far more complicated. I leave them to much more complicated minds.

So maybe that admonition holds. Let me just ask you one more question. How much should we worry that a decrease in the strength of the dollar could become more of a cascade and it gets to places where we wouldn't want the dollar to be for a whole lot of both domestic and international reasons. How much do you worry about that? That is the great worry everyone has, not where the dollar exactly is versus the Euro or any other currency. But if we do not stay with that strong dollar and bolster it, we do not have any control over this because it is so much in the hands of the great herd, as Thomas Freedman calls it, the traders. And that instead of it ratcheting down a few percentage points, or ten, it just starts going down. Do you worry about that? Is that a real worry? Apart from anything that the Treasury Secretary said.

Mr. FISHER. The most important thing to recall is that we have had a floating exchange rate regime for almost 30 years now. The markets go up and down.

I have felt that, and part of my job over the last decade both here and in my previous employment has been to lean against some of the conventional wisdom.

Some people look out at markets and try to understand them by canvassing their available theories. They look back in their textbooks and if they find a theory, they say, well, there, I have my theory. Now it fits the market behavior, whether it is interest rates or exchange rates.

I view one of the things that I have brought to this endeavor is to remind—excuse me—to go back. But if people look in their textbooks and they cannot find a theory, then they say, it is just a bunch of 30-year-olds shouting at TV screens.

I have always reminded people, it is always 30-year-olds shouting at TV screens, whether you have a theory that explains it or not. And they are trying hard to be rational actors with the incentive structures they work with.

Now sometimes they do things that we have a hard time understanding. And the best thing that I have always tried to do is to try to understand what is motivating their behavior as a way to understand it.

I think that we get in a very odd, circular loop when the traders are trying to understand the official utterances and the thing goes around a little circle, and I think that is probably a counter-productive place to be, and that is why the less verbal intervention we have, the better.

Senator SCHUMER. But that both says yes and no to my question. It says the 30-year-olds could take us on a tear in a place we wouldn't want to go. Right?

Mr. FISHER. It is possible. I do not know what probability to attach to it.

Senator SCHUMER. All right. Well, anyway, I want to thank you, Mr. Chairman. I want to thank you, Mr. Fisher, and our other witnesses. I apologize for the brevity. It is an interesting hearing. I am glad we are holding it. And I am sorry that conflicts occurred.

Mr. FISHER. Thank you.

Senator BUNNING. Thank you, Mr. Fisher, very, very much for being here.

Mr. FISHER. Thank you.

Senator BUNNING. If the second panel would come forward: Wayne Angell, the former Member of the Board of Governors of the Federal Reserve; James Stuckert, Chairman and CEO of J.J.B. Hilliard and W.L. Lyons, Louisville, Kentucky; and Mark—I am going to say Zandi——

Mr. ZANDI. Yes, that is correct.

Senator BUNNING. Chief Economist, Economy.com.

Mr. ZANDI. Yes, thank you.

Senator BUNNING. Mr. Angell, it is good to see you again. If you would like to start with your testimony, we are ready.

STATEMENT OF WAYNE D. ANGELL FORMER FEDERAL RESERVE GOVERNOR

Mr. ANGELL. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to testify today on the subject of the use of economic policy to speed up economic growth in our economy that has been mired too long in recession. This is a very welcome opportunity to address the particular difficulties faced by an economy in the throes of a capital goods cycle beset by risk of deflation. Half-way measures are handicapped at the outset by a tendency to underestimate the lingering power of previous episodes of policy restraint. Both monetary policy and fiscal policy are likely to be deemed stimulative or accommodative even while policy continues to retard economic growth. If policy had been accommodative then economic performance would not long be regarded as a problem.

Now to make matters worse, the capital goods investments that we have seen and the capital goods technology have increased our capacity to growth this economy so much, that we could grow this economy at a 6 percent real rate for 6 years and not over-pressure our labor force. So the gap is large.

We would not be hearing warnings about the risk of deflation if monetary policy had not been less accommodative than reported. We would not be beset by such a rapid and prolonged decline in equilibrium interest rates if fiscal policy had switched from restraint to stimulation. This problem is so severe, that at the outset, we need to define fiscal stimulus as a fiscal policy that would produce a Federal budget deficit even when labor and capital resources are fully employed. The current Federal budget deficit is not stimulative as the deficit only exists due to the reduction of tax receipts forthcoming from an economy seriously underutilizing its resources.

Before we get to the question as to whether or not economic policy response might be the right course of action, I think it is important for us to look at the incoming data to see the nature of this downturn.

First, as you can see by Chart 1, which actually is the last chart in the packet, nonfarm payroll employment has declined in 24 of the last 25 months to bring April employment as a percent of peak employment to the lowest level of the recession.

Now many talk about the recession in the past tense. I do not use that tactic because, to me, a recession is a period in which employment is declining. And as you look at this chart, you can see that the employment is farther below the peak, 1.6 percent, than it has been at any time since the recession began.

Labor markets continue to be weak. The weekly unemployment claims numbers we had this morning once again showed that there is no sign this employment recession has ended.

Although the decline in employment has only been 60 percent as deep, and the decline in output only 70 percent as deep as in the 1981–1982 recession, as you can see in Chart 2, it is a record since the 1930's in regard to the length of the employment decline.

This is a capital goods downturn rather than a typical inventory cycle. As depicted in Chart 3, the total index of industrial production has declined only 6.7 percent from its April 2003 peak, whereas the index of business equipment production stands 18.5 percent below the peak month—indeed, this is a capital goods cycle.

Six months after the March 2001 employment peak economic activity was hammered by the September 11 terrorist attacks and many, I think, believed that the bounce-back from that post-attack doldrums amounted to a recovery. I do not agree.

Another misleading indicator of economic recovery emerged in 2002 as solid gains in labor productivity enabled output to expand while employment and hours worked declined.

Second, I think it is important for us to have a clear understanding as to why and how the 1991–2000 expansion came to an end. Was it simply that we had an unprecedented coincidence of bad events, such as Y2K and an over-exuberant stock market or was there an economic policy failure that was decisive?

Sometimes the makers of economic policy become convinced that the best way to avoid an unwelcome event is to engage decisively in a new economic plan. That is exactly what happened in the 1990's when voices of alarm predicted a low savings rate in the United States would result in an unsustainable increase in imports in excess of exports until our indebtedness to the rest of the world would produce a global economic collapse. The chosen remedy was to pursue a large enough Federal budget surplus to offset deficient private-sector saving.

It worked.

In the four quarters to the second quarter of 2000, individual income tax payments to the IRS rose exactly twice as fast as the growth rate of personal income: 11.4 versus 5.7 percent.

The engine that had been driving our prosperity was an unprecedented capital goods boom that matched up with an unprecedented surge in capital goods technology. Disposable personal income took such a hit from the 11.4 percent increase in individual income tax payments that there was simply not a sufficient increase in disposable income to enable households to buy what had been produced.

When I saw those second quarter at 2000 income tax receipts figures, I knew we would soon be in a recession.

In the turning point year 2000, a second-, third-, and fourth-quarter slowdown in the growth of personal consumption expenditure coincided with a high rate of increase in capital good capacity that the return on capital goods plummeted. While interest rates on real capital were plunging in the second half of 2000, the FOMC action in lowering the target Fed funds rate was not begun until January 3, 2001. Even though the January 3 cut in the Fed funds target was followed by an unprecedented stream of rate cuts through the year 2001, it was not sufficient to have avoided an employment recession. But without the FOMC's unprecedented actions, results would have been far worse.

Although a tax rate cut was proposed by President Bush in early 2001, its enactment came in a compromise form that distributed nonincentive tax rebates in the third and fourth quarters of 2001 and implemented a phased-in tax rate reduction in fiscal years 2002, 2004, and 2006.

Even though the monetary policy and tax rate policy response was far from ideal, it seems appropriate to credit the FOMC and the Congress for alleviating the rate of decline in employment and output. The half-scale tax remedy did not prevent a recession, but it cushioned the recession's rate of decline. And you can see that in comparison to the 1981 events.

Now, I am going to skip most of the next section, but I am going to point something out as clearly as I can, Mr. Chairman. And that is, we all seem to understand that the growth of credit almost is identical to the growth of dollar GDP.

What everyone seems to misunderstand in our double-entry bookkeeping, the growth of credit is exactly the growth of debt. So when people oppose the growth of debt, they are opposing the growth of credit. To get our economy in a zero-inflation environment to grow at a 5 percent level, we must have a growth of credit at the 5 percent level. If credit is going to grow at 5 percent, then debt has to grow at 5 percent.

If the Federal Government does not want to be a player in the growth of debt as a percentage of Federal borrowing keeping pace with the necessity of the growth of debt in the economy as a percent of borrowing, then we force the growth of household borrowing as a percentage of household debt to rise to unsustainable levels. And the same happens in the business sector debt.

So if we have the Federal Government playing we are on strike in regard to our increase in borrowing, then it is important to understand that that requires then household borrowing to increase at a faster pace.

Now the only thing that saved us in this swing of the Federal borrowing is the fact that the Federal Reserve maintained enough liquidity to keep housing prices moving somewhat higher and the low interest rates prompted a huge amount of refinancing, which enabled us to take a lot of household debt and slide it under the house. And that is why household debt was able to be increased as rapidly as it has in the past. But no one needs to look to an increase in household debt to get this economy moving toward full employment. It just is not going to happen.

Business debt that was growing at an 8 percent rate in 2002, the growth of business debt was down to 2.8 percent.

So that ends the lesson in regard to the flow of funds data and the relabelling of debt as something that is positive because debt is the opposite of credit, and everyone knows we have to have more credit.

Is the stimulus of Federal borrowing offset by a crowding-out effect on private borrowing? Or, to put it another way, does an increase in Federal borrowing put upward pressure on interest rates?

The answer to the first question is a clear no. Crowding out only occurs when Government expenditures require resources to be taken away from private goods production. A reduction in tax rates increases incentives to invest and to produce more and does not produce any crowding-out effect.

Now the answer to the second question is yes. An increase in Federal borrowing will mean that interest rates will be somewhat higher than if we did not have an increase in the borrowing. But it is a far different matter to push the natural rate of interest up to 1 percent than to push it up to 10 percent.

So it is important to understand that we could have a problem with interest rates being too low, as well as a problem with interest rates being too high. If interest rates are too low, the reward for saving are too low to provide an adequate safe fixed income for people facing retirement or currently retired.

I think we need to identify that as a problem. If you think low-interest rates are nice, you should want to move to Japan. But my friends in Japan have experienced 12 very sad and painful years.

There is not likely to be any crowding-out effect from tax rate reductions. In the 1981–1982 recession, a tax rate cut worked to create jobs without any crowding-out effect. Now get this—the average monthly employment gain was 367,000 per month in the 22nd, 23rd, and 24th months past the peak of employment in July 1981. In contrast, the average monthly employment change in this recession in the same 22nd, 23rd, and 24th months was minus 87,000 per month after the March 2001 peak in employment. If economic policy should be geared toward an increase in employment then the 1981–1982 model warrants emulation.

Is monetary policy likely to work in a deflationary environment? Monetary policy always works as long as the target variable chosen is countercyclical. The FOMC has the choice of selecting one of three target variables.

I think maybe, Mr. Chairman, I will skip through that section. But I do want to mention that persistent economic growth rates below the growth rate of the labor force and the growth rate of capital goods capacity is a clear indication that the chosen target Fed funds rate has been too high to accommodate the money-hoarding preference of households and businesses. Selecting a lower target Fed funds rate will require an increased injection of monetary liquidity into the banking system.

The sixth question I want to consider is could monetary policy restore the desired price level and thus the desired economic growth rate without changing tax rates?

The pragmatic answer is not likely in a capital goods contraction as compared to a recession driven by an inventory correction. A persistent failure of the price level and the growth of output and employment to respond to significant cuts in the target Fed funds rate is evidence of fiscal restraint. Whereas, inventory recessions tend to be followed by a motive to increase production more than the increase in sales, in order to reverse previous inventory rundowns, capital goods recessions are not prone to such a predictable end. After a labor market has passed the “soft market” stage to a stage where labor market uncertainty has a cumulative depressing effect on “lifetime income perceptions,” then monetary easing alone is likely to be transmitted only through disruption of global exchange rates.

My advice is to choose a tax rate that is likely to increase the expected economic growth rate of the United States to keep the dollar strong and stable. Monetary policy alone runs a danger of providing "beggar thy neighbor" remedy to domestic deflation. In other words, the more than moderate 2003 decline in the exchange value of the U.S. dollar against the Euro is likely simply to have transferred deflationary pressures from the United States to Europe. This is less than acceptable economic policy leadership.

What tax proposals do I favor? The elimination of the double taxation of corporate income paid out in dividends is far better than any other proposal as it reduces our highest effective tax rates. The 15 percent capital gains tax rate and a 15 percent dividend tax rate still leaves a 44.75 percent combined tax rate.

Chairman Bunning, that to me seems way too high to have the kind of capital goods market that we need and we cherish.

There is simply more bang for the buck in eliminating double taxation as no other proposal will make common stock ownership so much more attractive. Not only does it eliminate the pernicious double taxation, but it also is likely to have the greatest effect in modifying corporate executive branch behavior to perfectly align the CEO's interest with shareholder interest. Why would top management wish to distribute the fruits of their labor in any other way than in paying dividends?

And the exclusion of qualified dividends from taxation will first increase the dividend payout ratio, then it will alter the choice of employed workers to reduce the amount of income deferred from taxation into company retirement plans in favor of direct stock ownership. And for retired workers it will encourage withdrawing funds from the retirement programs, paying the income tax, and then securing tax-free income. I am convinced that Federal tax receipts would increase between 2004 and 2010, as a result of the elimination of double taxation.

Although it seems the Congress may choose a combination tax rate of 15 percent for both capital gains and dividends, I continue to prefer the original model presented by the President.

Reducing maximum noncorporate business tax rates to the 35 percent corporate rate is essential to provide an optimum increase in jobs for American workers.

Thank you.

Senator BUNNING. Thank you, Mr. Angell.

Mr. Stuckert.

STATEMENT OF JAMES W. STUCKERT
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
J.J.B. HILLIARD AND W.L. LYONS, INC.

Mr. STUCKERT. Mr. Chairman and Members of the Committee, my name is James W. Stuckert and I am Chairman and CEO of Hilliard Lyons, based in the beautiful Bluegrass State of Kentucky. Hilliard Lyons is a full-service investment firm with one goal: To help individuals reach their investment objectives. Since investment counseling is our only business, increasing investment in the equity markets is vital to us. I am also Chairman of the Security Industry Association's, SIA, Regional Firms Committee, which represents the interests of regional-firm members. I thank the Chairman and the Committee for the opportunity to present my views on how to jumpstart the economy and increase investment in the equity markets.

Established in 1854, Hilliard Lyons is a member firm of the New York, American, and Chicago stock exchanges, National Association of Securities Dealers, and Securities Investors Protection Corporation. The firm offers one-on-one advice about stocks, bonds, options, retirement plans, money market funds, mutual funds, trust and estate planning, and investment management. We also research the investment potential of various companies and industries and we underwrite bonds for public improvements such as schools and highways, obviously, better known as municipals. Hilliard Lyons, a PNC Advisors company, has 550 financial consultants in 85 branches in Arkansas, Georgia, Illinois, Indiana, Kentucky, Michigan, Mississippi, North Carolina, Ohio, South Carolina, Tennessee, Virginia, and West Virginia.

Over the past 25 years, the securities industry has faced and has overcome many challenges. And these include processing ever-increasing volumes of trades, converting to a shorter settlement period, the development of many new investment vehicles, the globalization of markets, and a terrorist attack that affected our financial systems like no other seen in our time. While the transition to an era of fear and uncertainty is not a future we would have chosen for our country, that is the reality that faces us today. With a pragmatism that is uniquely American, we have tackled these new realities head-on and have done everything feasible to mitigate loss and confusion. Regaining the public's trust and confidence in the greatest capital markets in the world is critical to jumpstarting our economy.

One of the most important things we can do to restore confidence is to get the economy and markets rolling again. Indeed, as the markets go, so goes public trust and confidence. The monthly UBS/Gallup Index of Investor Optimism hit an all-time low of just 5 points in March 2003, but it surged 61 points in April, just as the markets began creeping upward. That increase presented the largest one-month jump in the Index's history, which started in 1996. Some of the increase in confidence may be due to the tough new regulations, protections, and sanctions mandated by the Sarbanes-Oxley Act. We are, however, unlikely to see a sustained restoration of investor confidence, investment, or economic growth, however, unless we as an industry continue to put the customer first.

Congress can also help boost the economy and the markets by passing President Bush's jobs and growth package. The elimination of the double tax on dividend income—the centerpiece of the plan—would enhance the long-term growth potential of the U.S. economy, promote job creation and higher wage growth, strengthen corporate governance, and put the United States on a much more equal footing with our major trading partners.

Current tax policy encourages corporations to rely too heavily on debt rather than equity financing because interest is deductible, while dividends are not. The bias favoring debt over equity financing, for example, led many companies to take on high levels of debt that left them vulnerable to the economic downturn. The President's proposal would improve the performance of our economy by relieving numerous distortions caused by the current corporate tax regime, including the income tax code's general bias against savings and investment.

The President's economic package has undergone many revisions as it has worked its way through the legislative process, and even today, a new version of the package is being discussed. Even so, the best route to renewed economic vitality is the complete elimination of the double taxation on dividends.

Ending the double taxation of dividends would help move our tax system to one that taxes income only once. This, in turn, promotes savings and investment, increased capital formation, job creation, and economic expansion. The increased economic activity would generate additional tax revenues that could offset a significant portion of the tax revenues foregone by the proposal.

The immediate impact of eliminating the tax on dividends would be an annual tax savings of approximately $30 billion, or 0.3 percent of our current GDP. This savings would be distributed broadly and shared by the more than 50 percent of U.S. households that own stock. Moreover, in the case of the tax cut on dividends, there are additional factors that would help boost the economy in the long run. Because the after-tax value of dividends would increase, investments in stocks would become more attractive. It has been estimated that the value of the equity market would increase by as much as 5 to 10 percent. And this increase in equity values would provide further economic stimulus through the wealth effect, for example, people spend more as their net worth increases. It is no accident that a rising stock market is a leading indicator of economic growth.

The initial approximately $30 billion in tax savings is actually a very conservative estimate because it assumes no change in the current dividend policies of U.S. companies. But it is likely that even more companies would issue dividends. Now that a tax cut on dividends has been proposed, companies that have previously retained large amounts of cash have said they may distribute some of that cash to shareholders.

As useful as a tax cut on dividends would be in reviving the current sluggish economy, the main benefits would be long-term. The double taxation of corporate earnings reduces companies' return on capital and therefore increases the cost of capital. Lowering the cost of capital by eliminating taxes on dividends would encourage companies to invest more in plants, equipment, and other capital stock, enhancing long-term growth and leading to more jobs and higher wages.

Importantly, eliminating the double tax on equity-financed investments would bring U.S. tax policy more in line with our major trading partners. With the exception of only the United States, all G7 countries provide protection against the double tax on dividends. In addition, the United States has the second highest dividend tax rate among the 30 OECD nations. Twenty-seven of the 30 OECD countries have adopted one or more ways of alleviating the double tax. Whether competing at home or abroad, the double tax makes it more difficult for a U.S. company to compete successfully against a foreign competitor.

According to the most recent IRS data, 34.1 million tax returns—or 26.4 percent of total tax returns, representing 71 million people—reported some dividend income in the year 2000. Of all taxpayers that claimed some dividend income in 2000, nearly half—45.8 percent—earned less than $50,000 in adjusted gross income, including dividends. This proposal would also benefit more than 13.1 million small-business owners or self-employed taxpayers. Importantly, almost half of all savings from the dividend exclusion would go to taxpayers 65 and older, thereby giving retirees an additional reliable, long-term source of income to supplement their Social Security earnings and other retirement savings. Also, it is estimated that the average annual tax savings for the 9.8 million seniors receiving dividends would be $936.

Perhaps the greatest long-term benefit from the elimination of the double taxation of dividends would be the incentives for companies to return to the principles of sound financial management. With half of American families invested in the stock market, nothing is more important to the securities industry than restoring the public's trust in the strongest capital markets in the world. While we cannot blame the bubble of the late 1990's and its painful aftermath on the tax system, the current system did little to reign in the excesses and in some cases contributed to them. From the standpoint of both shareholders and the health of our economy, companies should be encouraged to concentrate on real earnings.

In that vein, encouraging companies to pay dividends would limit excesses because dividends offer proof of real profits. The payment of dividends by a company may give investors a strong signal of the company's underlying financial health and profitability. Indeed, a firm cannot pay dividends for any length of time unless the company has the earnings to support such payments. In an environment where reported earnings are viewed with some skepticism, cash dividends will bolster the credibility of earnings reports. Moreover, the payment of dividends would better align the interests of shareholders and managers by allowing shareholders to participate in decisions regarding corporate investment. Finally, because dividends serve as a stronger foundation for long-term value, companies that pay them will have fewer motives to artificially inflate profits just to cause temporary increases in stock prices.

SIA correctly forecast the sub-par performance of the U.S. economy in the first quarter of 2003, as well as the further weakening in the current quarter. The depth and length of the downturn is uncertain, and will be determined by several interrelated variables. Among them are the expense of the reconstruction in Iraq, the direction of oil prices, how quickly consumer and investor sentiment rebounds, and whether the recent resumption of growth in business fixed investment will continue.

The SIA's view is that it is critical that we focus on stimulating business fixed investment, which contradicted traditional recessionary patterns by leading the economy into a downturn while consumption remained relatively strong. In this vein, not all fiscal stimuli are created equal, and the tax measures that are focused on investment are much more important than those that provide a short-term, transient boost to consumption. President Bush has focused on the dividend proposal as key to job creation. Capital formation, spending on machinery and equipment, and plant and facilities will stimulate job creation more than spurring incremental consumption.

Mr. Chairman, I commend you for holding a hearing to review the economic situation on how to jumpstart the equity markets. Our number one goal is regaining the public's trust and confidence in our industry and our capital markets, and we are doing everything we can to ensure that our customers' interests always come first. Sound economic policy, as embodied in the President's jobs and growth package, is also critical to reinvigorating our economy. I urge Congress to pass it quickly.

Thank you.

Senator BUNNING. Thank you, Mr. Stuckert.

Mr. Zandi.

STATEMENT OF MARK ZANDI
CHIEF ECONOMIST AND CO-FOUNDER
ECONOMY.COM

Mr. ZANDI. Thank you, Mr. Chairman.

I have prepared remarks that mostly center on the dividend tax proposal. They seem a little less relevant today compared to yesterday, since it looks like we are going to get an agreement. So what I thought I would do, if you think this is a good idea, I will just introduce myself. I have that written down here. And then I will just make five points that I think are important in regard to this.

Senator BUNNING. That's fine.

Mr. ZANDI. Good. My name is Mark Zandi. I am Chief Economist and Co-Founder of Economy.com.

Economy.com is an independent provider of economic, financial, country, and industry research designed to meet the diverse planning and information needs of businesses, governments, and professional investors worldwide.

My marketing guy actually wrote this.

[Laughter.]

Senator BUNNING. That's all right.

Mr. ZANDI. It doesn't go off my tongue as quickly as it probably should.

We have over 500 clients in 50 countries, including the largest commercial and investment banks, insurance companies, financial services firms, mutual funds, manufacturers, utilities, industrial and technology clients, and governments at all levels. In fact, the State of Kentucky is a very good client. We provide them the economic inputs that drive their revenue projections, although we are not responsible for their budget problems.

Senator BUNNING. Shortfall?

Mr. ZANDI. Yes.

[Laughter.]

We have it right. Economy.com was founded in 1990, and we are an employee-owned corporation. We are headquartered in West Chester, Pennsylvania, a suburb of Philadelphia. We also have an office in London and one in Sydney, Australia.

Let me make five points.

First, the economy is struggling. I think it is on the precipice of recession, if it is not already in recession.

Mr. Angell made a good case that it has never left recession. Not only is the economy's problems long-lived, but also they are very broad-based.

If you look across industries, these are industries that are laying off workers. All of manufacturing, from aerospace to vehicle manufacturing, commercial construction, wholesaling, distribution, retailing, investment banking, and now State governments are laying off as well. They have only done that three times since the Great Depression, and this is one of those times.

The problems are evident across the country, from coast-to-coast. I am just going to name some big economies from east-to-west that I think are still in recession by any metric. I do not think there is much debate. Boston and New York City in the Northeast; Atlanta and Dallas in the South; Detroit and St. Louis in the Midwest; Denver, the Bay Area of California, and Seattle in the West. All are in very severe, deep recessions. No sign of any let-up.

Interestingly enough, just for your own personal interest, Kentucky is struggling, but it is held up quite well relative to most other economies. It has performed much, much better than I would say most of the State economies across the country.

Senator BUNNING. Small business.

Mr. ZANDI. Small business, they certainly have been hurt very badly, yes.

Senator BUNNING. No, but that is the reason it is held up.

Mr. ZANDI. Yes, that is a very good point. Actually, most of the difficulties in our economy, interestingly enough, have been at large companies, large, big, publicly traded companies, I think for various reasons. Small businesses have struggled, but they have actually held up, you are right, a lot better than most.

Senator BUNNING. Lay-offs have not been as big.

Mr. ZANDI. Yes. The second point is that I do think that the economy is poised to grow. I do think that the excesses borne of the stock market bubble around Y2K have largely been worked off.

There was significant investment, excess investment in information technology. I think businesses have done a very good job of getting that back in line. In part, it is just due to the rapid pace of technology.

The average economic life of a piece of IT equipment is a little less than 4 years. For computer hardware and software, it is a little less than 2 years. If you just think back, most of that investment was done more than 2 years ago and now the economic life of the stuff is evaporating. And if businesses want to maintain their productivity gains that they have worked so hard to garner, they are going to have to start investing pretty soon.

We have started to see some pick-up in investment. Computer hardware and software investment has actually risen over the past year, modestly, but it has risen.

So, I do think that we are poised for growth. I think that our main problem now is a lack of confidence; and even on that front, I feel a little bit better, post-Iraq.

Confidence has improved. Consumer confidence has rebounded. The financial markets have seen a rather dramatic improvement. Equity prices are up 15 percent from their March nadir.

Even more importantly, the corporate bond market has enjoyed a very powerful rally. Spreads between corporate yields and Treasury bills have narrowed dramatically. That is a very good measure of the angst of investors. The narrowing in spreads have been most substantive in the lowest quality corporate bonds, junk bonds. And that is indicative of a rather sharp improvement in confidence.

Business confidence as well has improved. We have a survey that we conduct off of one of our websites of businesses across the country in many industries, in many different parts of the country, and that has improved dramatically since its low a couple of months ago. So, I think we are poised for growth.

Now having said that, my third point is that I think that fiscal stimulus is definitely needed. And I agree with you. I think the bigger, the better.

I think we are at a very fragile point and if things do not go exactly as scripted, we are going to have a big problem. Monetary policy, regardless of what the monetary theories are saying, is now treading in waters that they have never tread before, and it is going to create a great deal of—so far, everything is working. And the comments that the Chairman made a couple of weeks ago worked their magic. But I am not sure how many times he will be able to do that if the economy does not soon turn the corner. Again, I think the economy is at a very fragile point. Nothing can go wrong here.

Fiscal stimulus is very important. I would have much rather seen a much larger tax package myself. But I think a $350 billion tax package is a reasonable attempt. I think the potpourri of tax cuts that were included were a reasonably good effort at trying to get the economy going. All I can say is I hope it gets passed quickly and that stimulus is provided very quickly to the economy.

Now let me say something about the elements of the package. And this goes to my fourth point.

I personally think eliminating, as in the case of this package, scaling back the dividend taxation is neither here nor there for the economy in the near-term. It is not going to provide stimulus to this economy this year, or even next. And unfortunately, because of the sunset provisions, I think that reduces the efficacy in the long-run as well.

We are talking about investor confidence. How can investors have any confidence about values if they do not know what the tax policy is going to be?

Now everyone says, well, there is a very high probability that these sunset provisions will get the dividend tax extended long into the future. But investors just cannot attach 100 percent probability to it, particularly because they know we are running very large budget deficits. At some point, that is going to be a problem. And it may just very well be the case that that problem will become most evident when one of those sunset provisions are expiring.

I think the sunset provisions significantly reduces the efficacy of any benefit. I think the benefit, even if it were completely eliminated with no sunset provisions, is minor.

The value of eliminating dividend taxation completely is equal to the present value of the future stream of tax savings. Simple calculation—apply a reasonable discount rate. At most, you get 10 percent pop to the market. No, I think 10 percent is great, but it is down 40 percent, as you pointed out, from its peak. Now, I am not sure that investors really believe that even a 10 percent pop would change behavior very quickly. So, I am very skeptical that dividend tax reduction would do anything for the economy near-term. And as structured, because of the sunset provisions and other aspects of it, I am very skeptical that it is going to do anything for the economy longer-run, either. I think that is one part of the legislation that is—there is no downside to it, but it is neither here, nor there for the economy, long-run or short-run.

Then, finally, let me end with this.

Here are a couple of things that I think you should do very quickly. First, you should extend unemployment insurance benefits. The Federal program is expiring at the end of the month. That would be a huge mistake not to extend that one more time.

The pain in the labor market is very significant. The length and duration of unemployment is now 20 weeks. It is now longer than it was in the 1991 recession. You have a lot of very, very distressed households. Personal bankruptcy filings are at a record high and rising very rapidly. Delinquency rates on credit cards are at record highs. Mortgage foreclosure rates are at record highs. Auto delinquency and repossession rates are at record highs.

If that is not extended, that would severely exacerbate credit quality problems and may induce a contraction in consumer spending, and that is exactly what we do not need at this point.

Another thing I would do, and this is where I disagree with you. I think aid to State governments is vitally necessary. I think the contraction that will occur because of State government cuts that we are seeing now in jobs and programs and now tax increases, is going to significantly offset the economic benefit that you are now providing to the economy through these tax cuts, through the Federal fiscal stimulus.

I really do not see the downside to it, and I do not bind to the arguments that State governments overdid it in the boom times. If you look at State government spending as a share of GDP, it is no higher today than it was 30 years ago. If you look at State government employment as a share of total employment, it is lower today than it was 30 years ago. Government is no bigger, State government is no bigger than it was.

Then, moreover, the arguments that there is a moral hazard problem I think are specious. The idea being that if you help States out today, that they will get into a bigger trouble down the road, I think that that is a rather minor issue.

And frankly, in times of crises, we have always looked aside regarding moral hazard problems. We did that with Korea. We did that with Mexico. What is wrong with doing that with California, Kentucky, and Massachusetts?

So, I really do not see that argument at all. I think providing a check to a State government today would be a tremendous boost to the economy precisely because those programs are in place. The monies would go to the people who need it most very, very rapidly.

Finally, let me end with this. Another thing that we should think about, we are all focused on lowering the cost of capital. But in the same breath, we are all talking about jobs. We want to promote jobs, right? We want to get the economy to create jobs. Well, how do you do that? You lower the cost of labor. And what are the most important costs to businesses with respect to labor? Health care costs and pension costs.

My health care premiums for my employees is rising at a double-digit pace and it has been doing that for 3 years. Frankly, it is getting to be a very significant problem. And the real problem is there is no end in sight. If I do a calculation of the health care costs that I am going to face as a small business owner, it is prohibitive because I do not see any end to 10 percent, 15 percent health care premium increases for the next 10 to 15 years. As a result, you add that up. That is a very significant cost to businesses, particularly small businesses who are struggling to shoulder these health care benefit costs.

So, I think it is critical, vital that Congress quickly begins to address this more carefully because this is going to be a very significant problem. And frankly, I think that is one of the key reasons why businesses are more likely to invest in a piece of computer equipment, software or telecom equipment before they invest in a person. So even when the economy does improve, it will take a long time before we see any significant improvement in job creation.

Thank you.

Senator BUNNING. Thank you, Mr. Zandi.

First of all, thank you all very much for being here.

On accelerated tax depreciation, there is a 50 percent bonus depreciation for property acquired between May 1, 2003 and January 1, 2005. That is about 20 months. That is from May to December 2003 and all of 2004.

Small business expensing, we now have a $25,000 investment expensing. That is increased to $100,000 for 2003, 2004, and 2005.

Capital gains and dividend—unfortunately, we did not do what the Senate did. We did what the House did. So, we have a 15/5 capital gains tax rate, and that applies only after sales of May 6, 2003, and it sunsets the end of 2009. The dividend treatment is the same as the House bill, where it is 5 and 15. It applies to dividends from domestic corporations and certain foreign corporations. And that also sunsets in the year 2009.

Now let me get to some questions. That is just a rundown that my staff gave me out of the meeting that the President just had with those who are going to pass the bill tomorrow.

Governor Angell, you and I have agreed on a lot of things. But what do you believe will happen if we would not pass the stimulus package?

Mr. ANGELL. Mr. Chairman, I believe that not passing this stimulus package runs the risk of some very bad things happening.

Number one, we are going to go for a long, long time before we increase output at a rate in excess of the growth of labor productivity and, consequently, the jobless recovery can go on and on and on, wasting precious resources. To me, that is the biggest waste we can ever have, is to not have the opportunity for people that would like to have jobs, have jobs.

Our entire educational system is adversely impacted when students do not see graduates able to use their studies and to develop the kind of income that they would like to have.

The second very bad risk is a risk to U.S. global economic leadership. We have done a great thing in terms of formulating trade policies that leave us with almost a perfect capital competitive market. That is, real capital goods globally are very, very integrated. But fluctuating exchange rates can play havoc on what occurs. I just do not like to see the United States, who is in a better position to ward off deflation than any other countries, using this beggar-thy-neighbor policy of a lower exchange value for the dollar.

So, I strongly dislike the risk we are currently taking and I am not in agreement with the U.S. Treasury's position today.

Senator BUNNING. Talking down the dollar.

Mr. ANGELL. No. I just think that turns back—when I was a Member of the Board of Governors of the Federal Reserve System, we had a little bout of that when someone in the Administration thought that we could sell more cars if somehow or other we could get the dollar's value to go down. And for a country that relies upon the entire world's willingness to invest in our country, that is a very risky affair.

I advise central banks in Asia, monetary authorities in Singapore and Hong Kong. And when I am there, the one question they want to ask is should we maintain a high concentration in U.S. dollars?

Now when I was going over there as a member of the Bear, Stearns team, I was able to tell them, yes, you should. But today, I wouldn't be able to provide that kind of message.

So, to me, it is a very risky affair for world economic power with world economic leadership to be relying so heavily on interest rate reductions. Mr. Zandi can talk all he wants to about the higher interest rates. The fact of the matter is that interest rates are going to go lower, not higher. But these low interest rates, without the promise of a tax bill that will promote U.S. economic growth, and thereby, the rate of return on capital will rise, the dollar could be in significant trouble. And that is a huge, huge risk, not for just us, but for the entire global economy.

Senator BUNNING. We are going to pass the bill. I just wanted you to give me your opinion.

Mr. ANGELL. Well, I am pleased you are going to pass it.

Senator BUNNING. We have bought enough votes to do that.

Mr. ANGELL. Okay.

[Laughter.]

Senator BUNNING. We have at least 51. We may have 52.

Mr. Stuckert, just because you left Louisville, did not mean that you thought that you were going to get out of the rain. You brought it with you from Kentucky.

[Laughter.]

Mr. STUCKERT. You are right.

[Laughter.]

Senator BUNNING. In your testimony, you talked extensively about the President's dividend proposal. Now that you know some of the other factors that are in the proposal, would you like to comment on them?

Mr. STUCKERT. Well, I certainly share your comments earlier, Senator Bunning, relative to the fact that there is some tax on the dividends that you prefer not be there.

I am pleased that it will last until the end of the year 2009, and 15 percent being the maximum, should generate some people buying the dividend-paying stocks, of course. And hopefully, those particular companies, their cost of capital will be reduced.

I personally think, as we try to consult with individuals, that the total tax policy of the United States of America has been against investment and against savings.

It always appalls me that when we try to guide individuals in their financial well-being for retirement plans and all, there is no—with the exception of a little bit of an expanded IRA, which is not really going to be enough to attract major monies for retirement—people feel that they have been put upon by the fact that they have to pay a lot of taxes, number one, on their income; and in turn, when they invest into anything, they have to pay taxes again, not only to the Federal Government, but also the State.

That is obviously why the 401(k) plans have grown dramatically, because those are tax-free until they are taken out.

Actually, the dividend and the capital gains, I think that anything that aids investments and savings in particular for individuals, the Federal Government cannot take care of everybody.

At some point, taxation policy has to be such that it is very easy for the baby boomers—maybe it is too late for them—but the Gen Xers and all the rest of them, somebody has to sit down and say, this is a good deal for me. I will start saving money and not be penalized for doing so, and have the dividends and the interest that I am receiving from my savings be just taxed away from me.

So if this is the beginning, I just think it is a wonderful start. I think that, overall, our American economy is at a disadvantage vis-à-vis the G7, the OECD countries. These people have, relatively speaking, no double taxation on dividends.

I think that the elimination of the tax on dividends down to 15 percent will probably help corporations pay monies out to the stockholders and then they in turn will spend it in the best interests of their particular likes and dislikes. I just think that that will help. That is something to me that will revive confidence and revive the American economy in the process.

Senator BUNNING. Do you realize that the last time we lowered capital gains rates from 28 to 20, that the first year we did that, we had a spike of $75 billion in revenue. We finally have gotten the CBO and the OMB to score a reduction in the capital gains rate as a positive rather than a negative.

We used to have a terrible time with the OMB and the CBO trying to get that scored positive. Over 10 years, it kind of is a wash now, because people usually make that capital gains sale in the first or second year of a situation where they do have—not too many people have capital gains, and that is a big problem. But at least some do. And this will stimulate, in my opinion, some portion of the economy by creating new dollars to spend on other things.

Mr. Zandi, you were quoted in *The Wall Street Journal* by Alan Murray on January 28, 2003, saying: “A necessary condition for any improvement in the economy is getting Iraq behind us. It would be nice to get both, an end-of-the-war related uncertainty and a stimulus package. But the first is the most important.”

Well, do you consider the war with Iraq behind us?

Mr. ZANDI. Oh, yes. And it was very successful.

Senator BUNNING. Okay. The next in line is a stimulus package. You have heard the broad outlines of the stimulus package. Do you think that this is going to be a stimulus, or do you think that it is not? By the way, I want you all to know that in the Senate budget resolution, we put in the ability to front-load any kind of a reconciliation package by $190 billion in the first 2 years. And that is the reason that we have been able to construct this package for job growth the way it is constructed.

If we hadn't had that in there, it would have been pushed back over a 10-year period. If you do $190 billion in the first 2 years, that is a lot better, and have the $160 billion over the next 8 years——

Mr. ZANDI. I think the stimulus package is very positive, and it was a very good effort. It is a hodgepodge of different things. But I think when you add it all up, in totality, it will help. I am very happy that it passed as quickly as it did.

I would have been hopeful that it would have been passed a little bit quicker, but I think the war got in the way of that. Everyone was busy with lots of other things.

But I think policymakers have done a great job here. I think it will be very helpful.

Now let me say this. I wouldn't stop here.

Senator BUNNING. No, we are currently working on an international bill, also.

Mr. ZANDI. Yes. I do think that the economy is still very fragile, and nothing can go wrong. Everything has to go well. We need a little bit of luck in addition to the end of the war and the stimulus package to get through this without finding ourselves in some difficult straits.

Senator BUNNING. By the way, on the unemployment benefits that you suggested, we are working very hard to get either a 13-week or a 26-week addition before they expire.

Mr. ZANDI. That is great. And let me say one more thing about the stimulus package.

It is not so much the dollars and cents that matter. They do matter. I do not mean to downplay that. But what matters perhaps even more is the sense among business people and consumers that you are working hard at trying to do something, that you recognize that the economy is a problem.

Even if people have jobs, they are hanging on. Many are just hanging on—part-time jobs, self-employed because they have no other options. They are stepping out of the labor force altogether because there is just nothing suitable.

Just the mere fact that you are working hard and discussing and debating these things I think is very valuable.

I wouldn't let the debate and discussion end here. I think I would start talking about what is next, because all of us economists are all sitting here telling you, we are poised for growth. But, frankly, it is faith-based forecasting at its best.

All the data—I cannot point to a statistic that will say, proof positive that that is going to happen. We could all be dead wrong, and of course, we have been dead wrong in the past. So, I think I would be——

Senator BUNNING. The big thing I want you all to know, and Mr. Angell knows this probably better than most, is that the employment numbers always lag by about 6 to 9 months. But we have to see some upswing shortly, or we have to level off on the loss of jobs before we can start gaining jobs. The numbers usually in any kind of recessionary period or downturn, the last thing we see positive is job growth. We have to get some of that ready to go before we can see the unemployment numbers, instead of growing at 6¼ or 6.1, we have to see and do things that are necessary to be done.

One other thing you brought up and I want to talk to you a little bit about sending $20 billion to the States.

There is a law in Kentucky, whether you know it or not——

Mr. ZANDI. I did not know it.

Senator BUNNING. —that limits employment by State government. It is a law, at 33,000 employees. They have 38,500 employees in State government. If they just did it by attrition, we wouldn't be in the pickle we are in in Kentucky. And we are not in a big one like some others are. We wouldn't be spending more than we take in.

Now all the States are having that problem. But for the Federal Government to hand out checks and think that we are going to continue to hand out checks to offset their shortfalls is not, in my opinion, a good policy to get into, because we cannot do it next year or the following year.

And so, they are going to have to look at their internal problems, particularly their Medicaid problems. Kentucky has 42 different participations in Medicaid. They are only required to do 15. Those are the mandated programs. Our Medicaid shortfall in Kentucky is horrendous, comparatively speaking. And I think other States are very similarly disposed.

Mr. Angell, I want to ask you a loaded question. If you were the Fed Chairman, what would you have done differently with the monetary policy of this great country?

Mr. ANGELL. Well, Mr. Chairman, first of all, before I answer the question, I want you to know that, in my opinion, Chairman Greenspan has been an inordinate help to this country because I know central bankers all over the world. And I know that even though Alan did not act as fast as I would have preferred he acted in the last half of 2000, what he did and what he stayed with was far better than any other central banker that I know about.

Senator BUNNING. I won't dispute that. I agree with that.

Mr. ANGELL. So my view, which has been predominated by an index of core commodity prices, has never failed me in terms of indicating whether monetary policy is tight or easy.

This view for me suggests that monetary policy has been a lot tighter over this last 18 months that the Fed has been pleading its case that it is accommodative.

I always become very uncomfortable when a central bank evaluates itself and says, we want you to know that we have a policy that is accommodative. In my experience, central banks that say they are accommodative generally are not. I listened to the central bank of Japan say that for 8 of the last 12 years, they finally gave up even trying to say that, and the central bank in Japan is still too tight.

The Japanese central bank must tell the Japanese people what they want the exchange value of the yen dollar to be at the end of 2006. And they have not been willing to do that.

So, I am a hawk on inflation. I proved that during my voting years at the Board of Governors. But I am also a hawk against deflation. And recognizing this deflation risk is something that I think was sorely needed.

I give Alan Greenspan great praise for his decision to indicate that there is a great risk of deflation, disinflation being too steep, than the risk of inflation. And because of that, we have had a movement upward in 10-year Treasury bond prices and 5-year Treasuries and 2-year Treasuries and that is doing us a lot of good.

Senator BUNNING. The market is reflecting that in the return on those.

Mr. ANGELL. Yes. Now, Mr. Chairman, you did not ask me for a forecast, but I will give you one, anyway.

[Laughter.]

Senator BUNNING. Okay.

Mr. ANGELL. If this equity market does not indicate that it really is a bona fide, recognizable bull market by the time of the June 25 and 26 FOMC meeting, I think the FOMC will undoubtedly take the correct step of lowering the target Fed funds rate.

Senator BUNNING. I do, too. By 50 basis points.

Mr. ANGELL. I hope by 50 basis points. What many do not understand is that the demand for money is such that lowering the target Fed funds rate by 50 basis points will require a tremendous quantitative injection of reserves. I like that on all accords, except I would like it a lot better if the Treasury Secretary was being more committed to a strong dollar.

Senator BUNNING. Sometimes we can overcome what Secretaries of Treasury say. We did it, if you remember correctly, when Secretary Baker tried to talk down the dollar during his tenure as the Treasury Secretary, and we were able to overcome that. And I think we can overcome whatever anybody says by action. This stimulus package will, in my opinion, overcome our Secretary of the Treasury's misstatements about the dollar and the value of the dollar in regards to other currencies.

Mr. ANGELL. Mr. Chairman, I commend you for your optimism. I share that kind of optimism. I appreciate particularly the work that many of you have done in regard to achieving the results of this tax cut package that you have now achieved.

Senator BUNNING. Last, but not least, Mr. Zandi. You mentioned your problem with medical and furnishing insurance. It is a big problem not only you have, but also it is across the board in every company and every corporation.

What do you think about the proposals that are before the Congress on medical liability and the correction that we would like to see in that regard?

Mr. ZANDI. You are referring to the liability caps?

Senator BUNNING. I am referring to the ability to control in some manner the cost of medical liability.

Mr. ZANDI. I think that needs to be addressed. I think that is a big part——

Senator BUNNING. There is one that has already passed the House. The Senate has not acted. And I am just wondering how you feel.

Mr. ZANDI. I do think that the accelerating cost of medical liability is a large contributing factor to the rapid rise in health care costs, and obviously, health care premiums that businesses and all of us are paying. Therefore, I think that that is a place where Government can step in and should work to try to limit those costs.

Senator BUNNING. Gentlemen, I thank you all for your testimony. This hearing is adjourned.

Mr. ZANDI. Thank you.

Mr. ANGELL. Thank you.

Mr. STUCKERT. Thank you.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

[Prepared statements submitted for the record follow:]

PREPARED STATEMENT OF SENATOR JIM BUNNING

I would like to welcome Senator Schumer and all of my colleagues to the first hearing of the Economic Policy Subcommittee of the 108th Congress. I would also like to thank all of our witnesses for testifying today.

Today, we have the first of a series of hearings titled; "Jumpstarting the Economy." I am very concerned with the state of our economy. I am very worried about the possibility of a double-dip recession. I know that puts me at odds with more optimistic economic experts, like Chairman Greenspan, but we have disagreed before. We are not growing like we can, and we are not creating jobs. There are many reasons for this.

I believe Chairman Greenspan acted way to slow to cut rates back in early 2001. He should have cut them in the fall of 2000. The corporate governance scandals have hurt trust in the markets. Sarbanes-Oxley and other actions have helped, but it will take a long time for corporate America to rebuild that trust. September 11 had a devastating effect on our economy. The two wars we have had since then have also not helped.

The reason why most of these events have been so harmful to this economy is because they have created uncertainty in our markets. If there is one thing that shakes the markets, it is uncertainty. I am hopeful that our witnesses today will help us find a way to bring some certainty back to our markets.

Since the height of the bull market in March 2000, the stock markets' market value has been reduced by about $8.5 trillion. At the market's high back in early 2000, the market cap of the Wilshire 5000 totaled $17 trillion. By the time of the market's low in early October, the Index's market cap had shrunk by about half that amount, or about $8.5 trillion. We have a $10 trillion economy. We have had stock losses of $8.5 trillion in 3 years. It is not surprising that investors are skittish.

Therefore, if we are going to grow this economy, we have to get people investing again. We need to create capital so businesses have the ability to invest and grow. Before we adjourn for Memorial Day, we will be voting on a growth package. I think it is crucial that we send a package to the President for his signature. I wish the package was bigger, I hope $350 billion is enough to move a $10 trillion economy. But we must make this start. We must create jobs and we must make sure our economy grows.

We must bring some certainty back to the markets if we are ever going to grow this economy and prevent a double-dip.

Once again, I thank all of our witnesses for testifying today.

PREPARED STATEMENT OF PETER R. FISHER

UNDER SECRETARY FOR DOMESTIC FINANCE
OFFICE OF PUBLIC AFFAIRS
U.S. DEPARTMENT OF THE TREASURY

MAY 22, 2003

Chairman Bunning, Ranking Member Schumer, and Members of this Subcommittee, I am pleased you have chosen to hold this hearing on a top economic priority for our Nation, both now and for decades to come: Increasing investment.

For the immediate future, our challenge is to rebuild business appetite for taking risks on the future and thus for creating jobs. Looking farther into the 21st Century, a major challenge for our society is to pay for the collective retirements of my generation and those that follow, while keeping commitments to current retirees and those near retirement. Over both horizons, the central task for Government and for the private sector is boosting savings and investment. First, Government must examine and remove legal and regulatory obstructions to savings and investment. The President has focused our attention on the need to reduce the biases against equity investment. Second, to bolster investor confidence, shareholders should demand and firms should do a better job of disclosing their key indicators of business and financial performance and prospects—the ones they actually use in managing their businesses.

Our key macroeconomic challenge today is to face the aftermath of the extraordinary events of the 1990's. Federal Reserve monetary policy, global economic integration, and telecommunications advances combined to fuel real prosperity and higher productivity, but investors' overestimation of their impact contributed to a stock market bubble. We continue to live with the consequences of these events and the destruction of trillions in household wealth as the bubble burst.

Business investment began slowing in 2000, causing demand for labor to soften. Let's be clear where jobs come from. New jobs come from investment—the willingness of investors and entrepreneurs to put capital at risk in a business venture. The President has focused us precisely on that point: Sharpening the incentives for investors and entrepreneurs to invest in the most productive ventures. And higher productivity means higher wages and a stronger economy for everyone.

The task before us is much the same throughout this new century: To enhance incentives for private sector savings and investment. We are going to pay for the retirement and health care of the baby boom generation one way or another. We can increase private savings and investment, or we will reach lower standards of living in the future than we would otherwise.

How can Government and business achieve these goals now and in the future? The President has clarified the main task for us in Government: To remove the legal, tax, and regulatory distortions that discourage savings and investment.

There is no better example than the current double taxation of corporate dividends. No one defends this bias from first principles; and no other major industrial nation taxes profits at such a punitive effective rate. By taxing dividends twice, our tax code encourages companies to retain earnings instead of paying them to shareholders; to raise excessive levels of debt; and to dedicate some of America's leading minds to tax minimization instead of job creation. And by imposing a high marginal rate on profit, our tax code thins the vital blood of economic growth: Risk capital.

We are encouraged by the good progress being made on the President's Jobs and Growth proposal, including progress toward lowering tax barriers to savings and investment. We are working with the Congress to obtain the best package possible, as quickly as possible. The President has made clear that the sooner we get this done, the sooner we can create jobs and put people back to work.

Boosting savings and investment in America will also require restoring investor confidence. Congress passed Sarbanes-Oxley, and the SEC and Justice Department are successfully implementing its provisions to improve corporate governance. But companies too have responsibilities to lead—to provide investors with meaningful, high-quality information. This is not principally a task for Government to achieve.

Our securities markets are extremely efficient at pricing and allocating capital on the basis of all available information. Unfortunately, important information is too often not available to shareholders. We will not restore our investor confidence until shareholders truly can see the companies in which they invest through the eyes of their agents in management, until they can see the real, economic leverage and the key indicators of business value that insiders can.

When investors have a picture of the real, economic leverage employed, regardless of the distractions of off- vs. on-balance sheet distinctions, attention will naturally turn to cash flow: To how management expects to pay down the leverage and still have some income left over for the shareholders. Exposing true leverage—contractually obligated net present value—is the only way that shareholders and creditors can judge true performance and can distinguish profit from business operations and from financial engineering.

Private sector leaders must transform the practice of corporate disclosure, to set a new class of best practices that will genuinely inform investors about the risk/reward prospects of the firms in which they invest. I wish that Government could set best practices by fiat; I do not think it can. Only the private sector—corporate executives, lawyers, accountants, bankers, analysts, and money managers—can make it happen.

The President has urged us to focus on this top national economic priority: Encouraging investment. Sharpening the tax incentives and improving corporate disclosure are crucial steps toward that goal—both to create jobs now and to generate the wealth later to pay for our collective retirement.

PREPARED STATEMENT OF WAYNE D. ANGELL

FORMER FEDERAL RESERVE GOVERNOR

MAY 22, 2003

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to testify today on the subject of the use of economic policy to speed up economic growth in an economy that has been mired too long in recession. This is a very welcome opportunity to address the particular difficulties faced by an economy in the throes of a capital goods cycle beset by risks of deflation. Half-way measures are handicapped at the outset by a tendency to underestimate the lingering power of previous episodes of restraint. Both monetary policy and fiscal policy are likely to be deemed to be stimulative or accommodative even while policy continues to retard economic growth. If policy had been accommodative then economic performance would not long be regarded as a problem.

We would not be hearing warnings about the risk of deflation if monetary policy had not been less accommodative than reported. We would not be beset by such a rapid and prolonged decline in equilibrium interest rates if fiscal policy had switched from restraint to stimulation. This problem is so severe that at the outset we need to define *fiscal stimulus* as a fiscal policy that would produce a Federal budget deficit even when labor and capital goods resources are fully employed. The current Federal budget deficit is not stimulative as the deficit only exists due to the reduction of tax receipts forthcoming from an economy seriously underutilizing its precious resources.

First, a question arises as to whether or not an economic policy response would be an efficient remedy to the current recession. But before we get to that question let's take a look at what incoming data are telling us about this downturn.

- This is the longest employment recession since the 1930's. Non-farm payroll employment has declined in 24 of the last 25 months to bring April employment as a percent of peak employment to the lowest level of the recession. Chart 1 compares the slow and the persistent decline in employment in this cycle as a percent of the peak employment to the steeper yet shorter decline in the 1981–1982 recession.
- Labor markets continue to be weak as business managers are able to reduce labor costs by capital investments and restructuring—labor productivity has continued to post sizable gains. Weekly unemployment claims show no sign that this employment recession has ended.
- Although long in duration the decline in employment has been only 60 percent as deep and the decline in output only 70 percent as deep as in the 1981–1982 recession. See Chart 2.
- This is a capital goods downturn rather than a typical inventory cycle. As depicted in Chart 3 the total index of industrial production has declined, so far, only 6.7 percent from its April 2003 peak, whereas, the index of business equipment production stands 18.5 percent below the peak month—and indeed, this is a capital goods cycle.
- Six months after the March 2001 employment peak economic activity was hammered by the September 11 terrorist attacks on the World Trade Center and the Pentagon. Recovery from the terrorist event gave a false impression of economic recovery.
- Another misleading indicator of economic recovery emerged in 2002 as solid gains in labor productivity enabled output to expand while employment and hours worked declined.

Second, it is important to have a clear understanding as to how the 1991–2000 expansion came to an end. Was it simply that we had an unprecedented coincidence of bad events such as Y2K and an over-exuberant stock market or was there an economic policy failure that was decisive?

- Sometimes the makers of economic policy become convinced that the best way to avoid an unwelcome event is to engage decisively in a new economic plan. That is exactly what happened in the late 1990's when voices of alarm predicted that a low saving rate in the United States would result in an unsustainable increase in imports in excess of exports until our indebtedness to the rest of the world would produce a global economic collapse. *The chosen remedy was to pursue a large enough Federal budget surplus to offset deficient private sector saving.*
- In the four quarters to the second quarter of 2000 individual income tax payments to the IRS rose exactly twice as fast as the growth rate of personal income: 11.4 versus 5.7 percent.
- The engine that had been driving our prosperity was an unprecedented capital goods boom that matched up with an unprecedented surge in capital goods technology. Disposable personal income took such a hit from the 11.4 percent increase in individual income tax payments that there was simply not a sufficient increase in disposable income to enable households to buy what had been produced.
- In the turning point year 2000 a second, third, and fourth quarter slowdown in the growth of personal consumption expenditure coincided with such a high rate of increase in capital goods capacity that the return on capital goods plummeted. While interest rates on real capital were plunging in the second half of 2000, FOMC action in lowering the target Fed funds rate was not begun until January 3, 2001. Even though the January 3rd cut in the target Fed funds rate was followed by an unprecedented volley of rate cuts through the year 2001, it was not

sufficient to have avoided an employment recession. But without the FOMC action results would have been worse.

- Although a tax rate cut was proposed by President Bush in early 2001, its enactment came in a compromise form that distributed nonincentive tax rebates in the third and fourth quarters of 2001 and implemented a phased in tax rate reduction in fiscal years 2002, 2004, and 2006.
- Even though the monetary policy and tax rate policy response was far from ideal, it seems appropriate to credit the FOMC and the Congress for alleviating the rate of decline in employment and output. The half scale tax remedy did not prevent a recession, but it cushioned the recession's rate of decline.

Third, let's consider some facts to be learned about deficits and debt from a review of the data from the Federal Reserves Flow of Funds statistical base:

- Economic growth in current dollars ($GDP) averaged 5.0 percent from 1991 to 2002 matching the growth of total sector borrowing as a percent of total sector debt which averaged 5.2 percent by an arithmetic mean and by 5.1 percent by a median. Total sector borrowing rates during these 12 years is considerably lower than the 7.8 percent average for 37 years from 1965 to 2002—a lower inflation rate reduces the rate of growth of debt necessary to sustain an expansion. Think how much worse this decline would have been if we had entered the recession with a 12 percent rate of inflation.
- When Federal borrowing as a percent of Federal debt actually declined at a 3 percent annual rate as it did from 1998 to 2001 then borrowing from non-Federal sectors must necessarily have increased enough to make up for negative Federal borrowing contribution. Household borrowing as a percent of household debt increased to a 7.7 percent rate up from the 12-year average of 6.8 percent. And business borrowing surged from its 12-year average as a percent of business debt from 5.1 to 8.8 percent.
- But the problem with requiring a surge in household borrowing and business borrowing to offset a decline in Federal borrowing is that households and businesses are not able to sustain such a high increase in borrowing as a percent of debt. The result was not only a 2002 slowdown in business borrowing as a percent of business debt to 2.8 percent, but also a slowdown in total borrowing to a level insufficient to maintain an expansion of output. Give credit to the FOMC for providing sufficient liquidity to enable the price of houses and condominiums to continue to move somewhat higher and thereby provide a sufficient level of equity extraction to enable households to continue a spending pace sufficient to keep output growth positive.

Fourth, is the stimulus of Federal borrowing offset by a crowding-out effect on private borrowing? Or, put another way, does an increase in Federal borrowing put upward pressure on interest rates?

- The answer to the first question is "No." Crowding out occurs only when Government expenditures require resources in competition with the production of private sector goods. A reduction in tax rates increases incentives to invest and to produce by leaving buying power in the private sector. There is no crowding-out.
- The answer to the second question is "Yes." But it is a far different matter to push the natural rate of interest up to 1 percent than to push it up to 10 percent. The problem today is that interest rates are too low to provide a meaningful reward for saving and too low to provide an adequate safe fixed income for people facing retirement or currently retired.
- There is not likely to be any crowding-out effect from tax rate reductions. For example in the 1981–1982 recession, a tax rate cut worked to create jobs without any crowding-out effect as the average monthly employment gain was 367,000 per month in the 22nd, 23rd, and 24th months after the July 1981 peak in employment. In contrast, the average monthly employment *change* was minus 87,000 per month in the 22nd, 23rd, and 24th months after the March 2001 peak in employment. If economic policy should be geared toward an increase in employment then the 1981–1982 model warrants emulation.
- Given that the FOMC has now recognized that the risk of deflation exceeds the risk of inflation, interest rates are more likely to remain too low for several years. It is a time to understand that economies besieged by a disinflation to deflation risk are likely to be in a low-interest rate environment for many years to come. The only likely escape is through the incentives of tax rate reduction.

Fifth, is monetary policy likely to work in a deflationary environment?

- Monetary policy always works as long as the target variable chosen is countercyclical. The FOMC has the choice of selecting one of three target variables: A target Fed funds rate, a target growth of reserve bank credit or a target price level. Any one of these target variables could work to counter deflation.

- The FOMC has chosen to target the Fed funds rate as a way to measure out the amount of monetary liquidity additions and subtractions. Consequently, I will confine my focus to selecting a target Fed funds rate that is likely to increase the growth rate of real economic output to a level sufficient to stimulate employment growth. The problem with monetary policy in long-cycle periods is not that monetary policy runs out of ammunition, but that the monetary authority quite often misjudges the degree of economic restraint contained within a chosen target Fed funds rate.
- Persistent economic growth rates below the growth rate of the labor force and the growth rate of capital goods capacity is a clear indication that the chosen target Fed funds rate has been too high to accommodate the money hoarding preference of households and business. Selecting a lower target Fed funds rate will require an increased injection of monetary liquidity into the banking system.
- A reduction of the target Fed funds rate from 1.25 to 0.75 percent would require a significant injection of liquidity to bring a supply of liquidity consistent with a 0.75 percent rate. It is monetary nonsense to argue that "quantitative easing" can provide more liquidity at the existing Fed funds rate. Any increase in the supply of reserves would result in a lower Fed funds rate. As long as the Fed funds rate is positive the FOMC is likely to want to measure its quantitative easing by the extent of the change in the Fed funds rate.

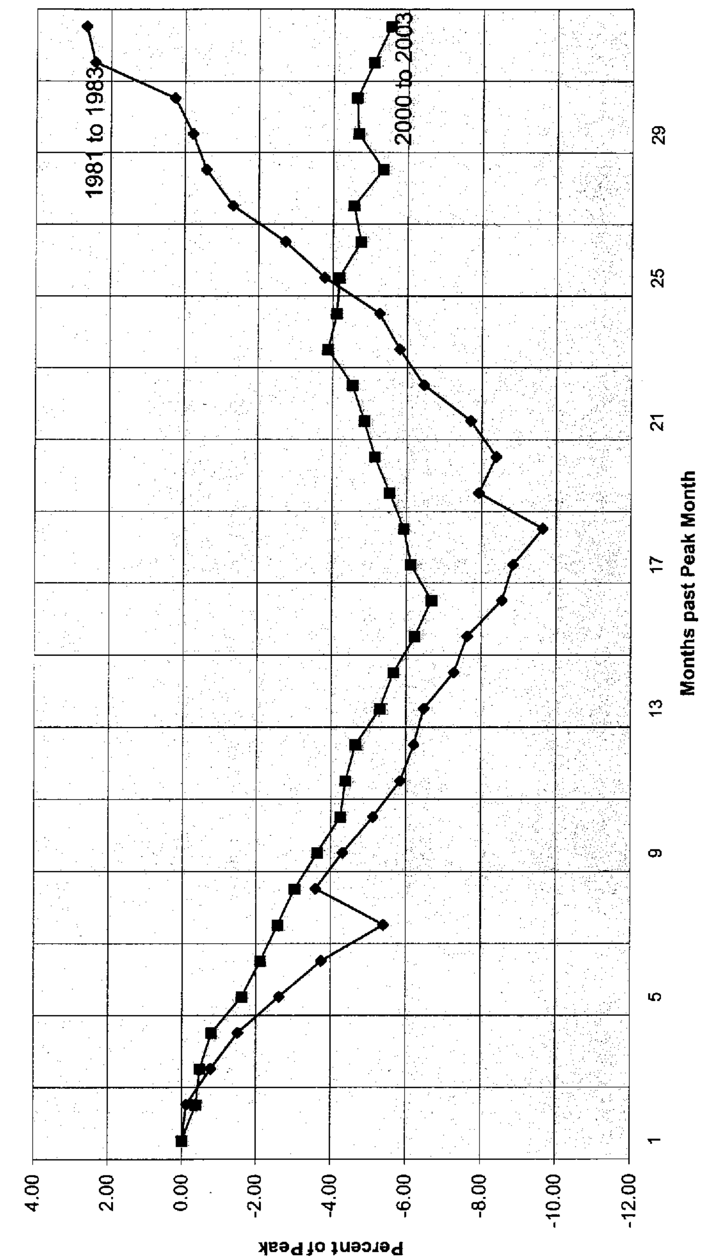
Sixth, could monetary policy restore the desired price level and thus the desired economic growth rate without changing tax rates?

- The pragmatic answer is "not likely" in a capital goods contraction as compared to a recession driven by an inventory correction. A persistent failure of the price level and the growth of output and employment to respond to significant cuts in the target Fed funds rate is evidence of fiscal restraint. Whereas, inventory recessions tend to be followed by a motive to increase production more than the increase in sales, in order to reverse previous inventory rundowns, capital goods recessions are not prone to such a predictable end. After a labor market has passed the "soft market" stage to a stage where labor market uncertainty has a cumulative depressing effect on "lifetime income perceptions" then monetary easing alone is likely to be transmitted only through disruption of global exchange rates.
- My advice is to choose a tax rate reduction that is likely to increase the expected economic growth rate of the United States sufficient to keep the dollar strong and stable. Monetary policy alone runs a danger of providing "beggar thy neighbor" remedy to domestic deflation. In other words, the more than moderate 2003 decline in the exchange value of the U.S. dollar against the Euro is likely to have simply transferred deflationary pressures from the United States to Europe and Japan. That is less than acceptable economic policy leadership.

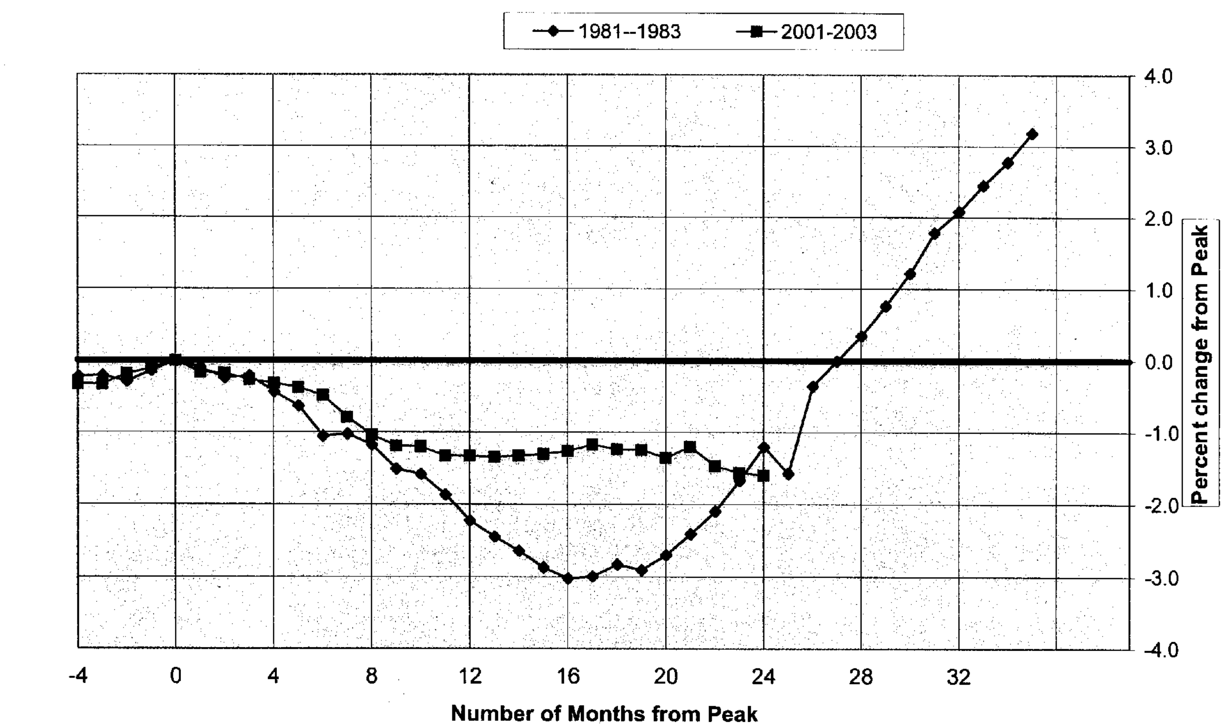
Seventh, what tax rate proposal do I favor?

- The elimination of the double taxation of corporate income paid out in dividends is far better than any other proposal as it reduces our highest effective tax rates.
- There is more bang for the buck in eliminating double taxation as no other proposal will make common stock ownership so much more attractive. Not only does it eliminate the pernicious double taxation but also it is likely to have the greatest effect in modifying corporate executive branch behavior to perfectly align the CEO's interest with shareholder interest. Why would top management wish to distribute the fruits of their labor in any other way than in paying dividends.
- The exclusion of qualified income from taxation will first increase the dividend payout ratio then it will alter the choice of employed workers to reduce the amount of income deferred from taxation into company retirement plans in favor of direct stock ownership. And for retired workers it will encourage withdrawing funds from retirement programs, paying the income tax, and then securing tax free income. I am convinced that Federal tax receipts would increase between 2004 and 2010 as a result of the elimination of double taxation.
- Although it seems the Congress may choose a combination tax rate of 15 percent for both dividends and capital gains, I continue to prefer the original model presented by the President as it is much more likely to provide the surge in common stock values. We have never moved from recession to recovery without first seeing a new bull market in common stocks.
- Reducing maximum noncorporate business tax rates to the 35 percent corporate rate is essential to provide an optimum increase in jobs for American workers.

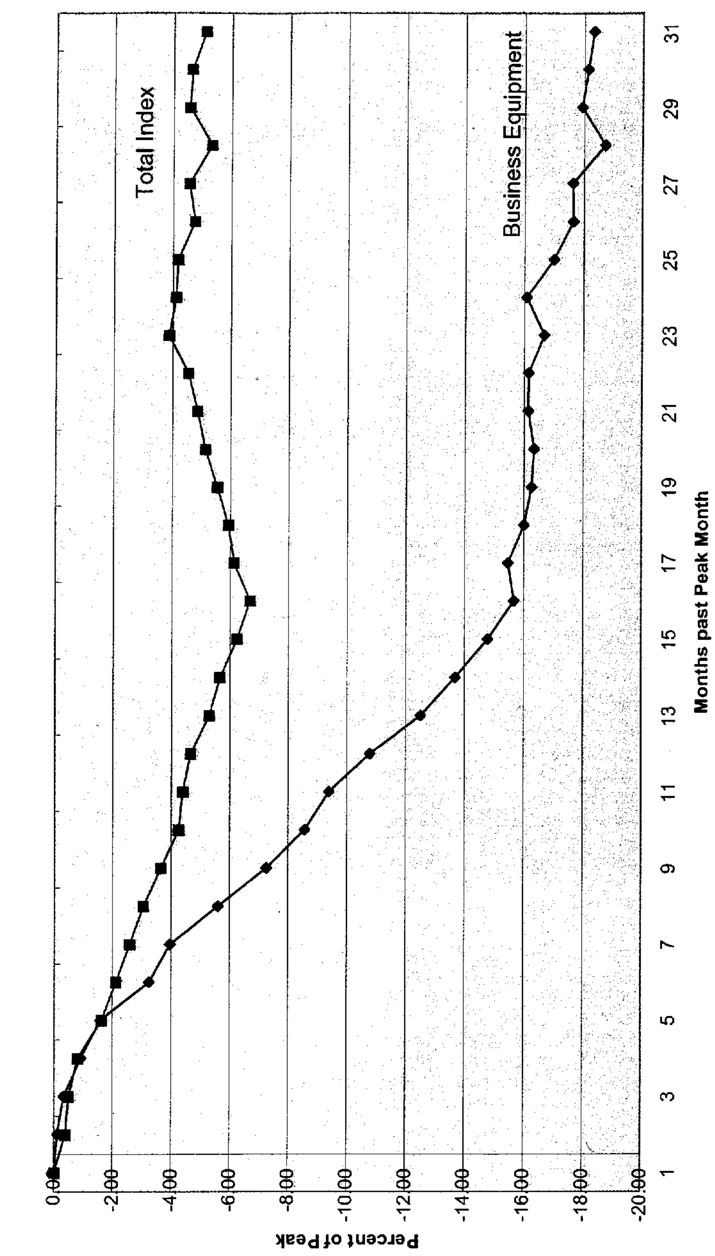
INDUSTRIAL PRODUCTION 2000 to 2003 CYCLE COMPARED TO 1981 to 1983 CYCLE



EMPLOYMENT AS A PERCENT OF PEAK EMPLOYMENT



INDUSTRIAL PRODUCTION 2000 to 2003 CYCLE



PREPARED STATEMENT OF MARK ZANDI

CHIEF ECONOMIST AND CO-FOUNDER, ECONOMY.COM

MAY 22, 2003

Mr. Chairman and Members of the Subcommittee, my name is Mark Zandi, I am the Chief Economist and Co-Founder of Economy.com.

Economy.com is an independent provider of economic, financial, country, and industry research designed to meet the diverse planning and information needs of businesses, governments, and professional investors worldwide. We have over 500 clients in 50 countries, including the largest commercial and investment banks; insurance companies; financial services firms; mutual funds; manufacturers; utilities; industrial and technology clients; and governments at all levels.

Economy.com was founded in 1990. We are an employee-owned corporation, that is headquartered in West Chester, Pennsylvania, a suburb of Philadelphia. We also maintain an office in London.

I will make three points in my remarks. First, the economy is struggling significantly, and a well-designed fiscal stimulus plan that is passed quickly would be useful in jumpstarting the economy and by extension the equity market. Second, while the elimination of the double taxation of corporate income is a laudable economic objective, doing so will provide only a small boost to the equity market, and do little to support the economy's near-term prospects. This is particularly true of the current proposals to simply scale-back dividend income taxes for a limited period. Third, the long-term economic benefits of the proposals to scale-back dividend income taxes are also small, as any gains to economic efficiency are all but offset by the economic drag resulting from larger budget deficits and higher interest rates.

Fiscal Stimulus

The need for more fiscal policy stimulus is motivated by the struggling economy that is operating well below its potential. The economy is posting gains in real GDP, but those gains are barely half those necessary to support any meaningful job growth and a stable unemployment rate.

Adding to the pernicious character of the economy's current problems is that they are extraordinarily broad-based. Industries as wide-ranging as manufacturing, commercial construction, travel, retailing, investment banking, and now State governments are reducing payrolls. The economy's difficulties are also widespread from coast-to-coast. Large economies ranging from Boston and New York in the Northeast, to Atlanta and Dallas in the South, to Chicago and Detroit in the Midwest, to the Bay Area of California and Denver in the West, are engulfed in full-blown recessions.

Near-Term Impacts

Fiscal stimulus is needed to jumpstart the economy and by extension the stock market, but such stimulus must be well-designed and it must be provided quickly. Scaling back dividend taxation, particularly as envisaged under the plans currently being debated, will provide at best only marginal support to the economy this year and early next, when it needs it most.

The link between scaling-back dividend taxation and the economy's near-term performance is largely through stock prices. Stock values will rise by an amount equal to the present value of the stream of future tax savings. With approximately only one-half of individual dividend income excluded from taxation, under the current plans, stock values will receive an estimated boost of no more than 5 percent. The increase in stock prices will occur quickly as investors discount the tax benefit. Indeed, at least part of this benefit may already be discounted in current stock prices, as investors have likely attached some probability to some reduction in dividend income taxes.

A key conduit through with higher stock prices affect the economy is through the positive wealth effects on consumers. The wealth effect postulates that households consider all their financial resources when deciding how much to spend and save. When household net worth rises, households are more willing and able to increase their spending out of income and thus save less. Conversely, when household net worth is falling, households are more anxious about their financial well-being and are less willing and able to spend out of income and thus save more.

The wealth effect from a change in stock values is estimated to be almost 2.5 cents. That is, for every permanent dollar increase in stock values, consumer spending ultimately increases by 2.5 cents. This wealth effect is distributed over nearly 3 years and is very small in the first year given that households must expect that any increase in wealth is permanent before changing their spending and saving behavior in response.

Higher stock prices also support the economy through a lower cost of equity capital for businesses. Businesses are able to issue new equity at lower cost to finance their growth, supporting stronger business investment.

The economic benefit of a positive wealth effect and lower cost of equity capital occurs with long lags. The lags are likely to be even longer in the current economic environment, which is characterized by a high degree of consumer and business angst and uncertainty. Given the approximately 40 percent plunge in stock values during the past 3 years, households will be skeptical that any increase in the value of their stock portfolios represents a permanent increase in the value of their portfolios. Without that expectation, households will be slow to increase their spending in response. Businesses will also be unlikely to quickly raise more equity capital to finance increased investment in response to any rise in stock prices. The equity market remains particularly unreceptive at this time to companies looking for capital to expand, and businesses remain exceedingly cautious in taking risks given heightened geopolitical concerns.

Mitigating the economic boost of scaling-back dividend income taxation is the higher long-term interest rates that will result. Like equity investors, fixed income investors will quickly discount the implications of such a change, most importantly being the larger long-term Federal budget deficits that will result from the lost tax revenues.

As is evident historically, larger long-term deficits result in higher long-term interest rates. During the first half of the 1980's, when the Federal debt was expanding at over a double-digit pace, real 10-year Treasury yields were over 8 percent. As debt growth slowed during the 1990's and fell during the later half of the decade, real Treasury yields were halved.

Interest rates on tax-free bonds such as municipal bonds will be under added pressure, as they compete for investable funds against the stocks of dividend paying companies.

Higher interest rates raise the cost of debt capital to businesses, at least partially offsetting the boost to investment provided by the lower cost of equity capital. The higher rates also constrains consumer spending on consumer durables and housing demand. This in turn weighs on near-term growth in house prices and housing wealth, at least partially offsetting the boost to consumer spending provided by the increase in stock wealth. The wealth effect out of housing wealth is an estimated 4.5 cents over a 3-year period. This is larger than the wealth effect out of stock wealth given the substantially broader ownership of housing. Well over two-thirds of households own their home, while not quite one-half of households own stocks.

Of all the tax cuts currently being considered by policymakers, scaling-back dividend taxation provides the smallest near-term economic stimulus. The near-term economic bang for the buck, or 1-year change in real GDP provided for a given dollar of lost tax revenue, is only 9 cents. This compares to a near-term economic bang for the buck of 59 cents for rolling forward the marginal personal tax rate cuts now legislated to occur next year and in 2006, for example, and 124 cents for providing direct aid to hard-pressed State governments, and 173 cents for extending emergency Federal unemployment insurance benefits.

Long-Term Impacts

The elimination or scaling back of dividend taxation does result in several important long-term economic benefits. Most importantly, it reduces the disadvantage the corporate sector now faces in the competition for capital. Under current law, some corporate income is taxed twice, but most small businesses are taxed only once at the personal level, and the imputed income on housing is not taxed at all. These differences in tax treatment lead to less investment in the corporate sector than is economically optimal.

Eliminating or scaling-back dividend taxation also reduces the current tax incentive businesses have to use debt over equity to finance their operations. The resulting over-leveraging of businesses does make them more vulnerable to financial problems during recessions, forcing them to undertake more draconian cost-cutting and thus exacerbating the downturn.

There are also long-term economic benefits as businesses will devote a higher share of their corporate income to paying dividends. Businesses will thus find it more difficult to temporarily lift their stock prices through stock repurchases and other financial engineering techniques. These strategies, which were very popular during the equity market boom of the late 1990's, likely result in inefficient corporate decisionmaking.

These economic benefits, however, are ultimately significantly offset by the higher actual and anticipated future budget deficits that result. As previously discussed, larger persistent deficits result in higher long-term interest rates. This weighs on business investment and ultimately productivity growth and the economy's long-term potential growth. Indeed, the economic drag of higher interest rates ultimately outweighs the economic benefits of eliminating or scaling-back dividend taxation.

The long-term economic bang for the buck, or 10-year increase change in real GDP provided for a given dollar of lost tax revenue, is estimated to be 20 cents. The most significant economic bang for the buck occurs 3 to 5 years after taxes are reduced, but due to the pernicious economic effects of higher interest rates, real GDP is lower by year 8.

Conclusions

The economy is struggling and while it is expected to avoid another recession given the very successful military action in Iraq, more Federal fiscal stimulus is needed. The fiscal stimulus plan policymakers are currently coalescing around is a good effort to provide that stimulus, although it must soon become law to be of significant help.

Scaling back dividend income taxation, however, will do little to jumpstart the economy. There are longer-term economic benefits to scaling-back dividend taxation, but they are significantly diluted under the plans being considered by the resulting higher budget deficits and long-term interest rates. The benefits of dividend tax cuts would thus be significantly enhanced if they were coupled with broader corporate tax reform that would result in a fiscally neutral change.

While such tax reform is laudable, it is a complex and thus time-consumer endeavor, and thus should not be included as part of the current fiscal stimulus plan.

JUMPSTARTING THE ECONOMY: RURAL AMERICA

WEDNESDAY, JUNE 25, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON ECONOMIC POLICY,
Washington, DC.

The Subcommittee met at 2 p.m. in room SD–538 of the Dirksen Senate Office Building, Senator Jim Bunning (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. The Subcommittee will come to order. It is 2 o'clock, and I like to start things on time. A lot of people do not realize that.

I would like to welcome all of our witnesses to the second hearing of the Economic Policy Subcommittee of the 108th Congress. I am very happy that we have three of my fellow Kentuckians on the panel today.

Since our first hearing in May on increasing investment in equity markets, the Dow has gone up over 590 points, and the Nasdaq has risen over 115 points. I understand a tax bill might have passed that day, but I give full credit to our hearing. Hopefully, Chairman Greenspan will not mess things up today and will cut rates another 50 basis points. We will know in about 15 minutes. We want to bring the same results we brought to the equity markets to rural America.

For our second hearing, I would like to focus on the economics of rural America. During the tech boom of the 1990's, our economy experienced rapid growth. Productivity has increased at historic rates. The equity markets grew to record levels, so much so that there were many examples of janitors at tech companies becoming millionaires because of their stock options. I hope now they sold those stocks before the bubble burst.

Rural America, for the most part, did not experience that rapid growth. The tech boom did help, especially to increase productivity. Many farmers use global positioning systems, called GPS's, to assist in running their farms. The Internet has also been a huge help to make farmers more productive. But rural America did not experience the same highs many other parts of America did during the 1990's. Fortunately, they also have not experienced the same lows of this last recession, but they still lag behind.

I would like to talk about where we are today in rural America. What the state of the economy is currently, and what we see for its future. I would also like to talk about what we can do to help grow the rural economy. In many parts of Kentucky and the rest of the country, our young people are leaving the rural areas because they do not believe that they will be able to get jobs. Now, we must change that.

I am very happy to have the Administrator of the Rural Utilities Service, Hilda Legg, here today; also the Dean of the Kentucky School of Agriculture, Scott Smith; we also have the Vice President of the Kentucky Farm Bureau, Mark Haney. I used my Chairman's prerogative to stack the deck with Kentuckians. I am very thankful you agreed to take time out of your busy schedules to testify here today, and I look forward to hearing your testimony.

Ms. Legg, if you would like to start us off? And we will make all of your full statements part of the record, so you do not have to worry about that.

STATEMENT OF HILDA GAY LEGG
ADMINISTRATOR, RURAL UTILITIES SERVICE
RURAL DEVELOPMENT MISSION AREA
U.S. DEPARTMENT OF AGRICULTURE

Ms. LEGG. Thank you, Chairman Bunning, for this opportunity to participate in a hearing that, of course, I feel passionately and personally very committed to. It is a public forum for us to understand the problems and the challenges that rural America faces and to seek answers to those challenges. So, I am grateful for this opportunity.

As the Administrator of the Rural Utilities Service and as a part of USDA's Rural Development team, I work with our programs that provide financing for the infrastructure construction for electric power, telecommunications, and water and waste disposal services. I come from a background that includes building economic development in Kentucky, as well as with the Appalachian Regional Commission.

Our focus in the Rural Development mission area is to help rural areas achieve economic and social gains that are solid and long lasting.

The Federal Reserve Bank of Kansas City's Center for the Study of Rural America reports in their May Overview, that the rural economy continues to hold steady, with rural jobs very slightly gaining 0.7 percent in February compared to a year ago. Job growth is increasing at a very slightly higher percentage in rural areas compared to growth in metropolitan areas, according to the Bureau of Labor Statistics. And while no one is claiming this is a boom cycle, it appears that in the rural economy, at least we are heading in some of the correct directions.

Rural America is an eclectic mix of races, ethnic groups, terrain, climate, amenities, businesses, and institutions. While agriculture is certainly prominent, no one industry dominates the rural landscape as it did a couple of centuries ago, nor does a single pattern of population decline or growth exist for all rural areas. Diversity then presents opportunities for some creative answers and unique partnerships.

At the beginning of the 21st Century, according to the U.S. Census and the USDA's Economic Research Service, rural America comprises 2,305 counties, contains 80 percent of the Nation's landmass, and is home to 56 million people.

In Secretary Ann Veneman's book "Food and Agriculture Policy," she stated that despite the fact that seven out of eight rural counties are now dominated by nonfarming activities, that in no way diminishes the importance of ranching and farming in rural areas. However, in many communities, this diversity provides a strength that can help us to sustain through those times of not enough rain or too much rain, as recently.

Our challenge that we face from the infrastructure program is that while we have seen a serious downturn in the infrastructure development, especially in the telecom field recently in the more national picture, in our rural areas we do not have the problem of lots of dark fiber. That does not exist in rural America.

The fact is we have had to relearn an old lesson, that it really takes a good business plan, no matter what the technology that you are trying to deploy. High-speed telecommunications are absolutely mandatory for new job creation, not just for the future of rural America but also for today. Just like a good road, high-speed telecommunications requires a use for it to be beneficial, it must add to the economic structure of a rural area. There is no doubt that without that infrastructure being built, they will not come. Just to install broadband telecommunications capability without a plan of how to use it is a high stakes rolling of the dice.

Rural America finds itself in the midst of a revolution of change in the areas of telecommunications and electric infrastructure programs. The Telecommunication Act of 1996 has created an interesting and complicated landscape. While many of the larger providers have chosen to place their resources in the more densely populated areas of the country, but we see a vast number of entrepreneurs, from small traditional telecom companies to new start-up businesses, are stepping bravely into this new and hopefully competitive market in rural America. The general investment community is very hesitant today to finance telecommunications development needs, especially in rural communities. Therefore, the challenge of USDA is to provide funding for high-speed telecommunications development while continuing our history of high-quality loans that are a good use of taxpayers' dollars entrusted to us, Senator, by the Congress.

Clean, safe drinking water and ecologically sound waste disposal are equally vital aspects of both rural health needs and quality of life for rural citizens. There is no more basic human need than that of clean, safe drinking water.

In the electric infrastructure program, the development of renewable energy is not only improving the availability of energy to rural residents, but we are also seeing the development of what we call "power farming" as a potential new crop for farms and rural residents. Ethanol, solar, and wind are the most economically competitive energy sources, while bioenergy projects continue to improve the economic future for farms and rural businesses.

As a Nation, we are only as strong as our weakest link. It is always easy to look at the national numbers and percentages while forgetting the individual needs of rural citizens and communities.

Low percentages of unemployment sound a little hollow to that person who is unemployed. To him, it is 100 percent unemployment.

USDA, like any other Federal agency, does not have easy answers. We do find that by working with our rural partners and the community leaders, we can make gains in rural communities. And by one degree at a time maybe we can turn that ship around and in a different positive direction. The USDA Rural Development field staff, in State and local offices, still serves as our frontline in working directly with rural leaders for stronger communities.

Building quality infrastructure, housing, and businesses based on long-term plans and good business models, that is what will make our economy grow. Local leadership and citizens commitment is a key ingredient to making these programs work.

To create a new competitive edge for rural industries will require access to strong education to keep up with the changing world. It will require available capital for business development. And maybe most importantly, it will require strong rural leadership to make these things happen at that local level.

Thank you, Senator Bunning, for the opportunity, and I will be glad to answer questions whenever appropriate.

Senator BUNNING. Thank you, Ms. Legg.

Mr. Smith.

STATEMENT OF M. SCOTT SMITH
DEAN AND DIRECTOR, COLLEGE OF AGRICULTURE
UNIVERSITY OF KENTUCKY

Mr. SMITH. Thank you, Chairman Bunning, for the opportunity to share these remarks on rural economic development. In serving as Dean of the University of Kentucky College of Agriculture and also the Director of the Kentucky Cooperative Extension Service, I can assure you that rural economic issues play a very large part in shaping the mission of our organizations.

Rural counties and small cities in Kentucky, and throughout the Nation, face some significant economic challenges. The recent economic slowdown compounded with significant changes in the agriculture economy threaten job and income security in many rural areas. In some important ways, the current economic climate has had a relatively greater negative impact on some rural areas compared to metropolitan areas. Most notably, very recent downturns in rural manufacturing combined with some troubles in the farm economy are laying a combined one-two punch on many rural areas. For example, national manufacturing employment from 2002 declined by over 10 percent in rural areas of America compared with approximately 7 percent in metropolitan areas. Almost 140 rural factories closed last year.

Meanwhile, the rural service sector and rural construction activity would probably best be described as flat. Rural recreation and tourism apparently has not fully recovered from 9/11. And layered on top of this, in tobacco States like Kentucky, the shrinking quota and the changing tobacco program will continue to have dramatic effects, truly dramatic effects, not just on farmers but on entire rural communities.

Although the farm economy was widely described as recovering in 2001 and 2002, much of this advance was due to transfer payments. We all appreciate the uncertainty and the undesirability of relying on farm programs to sustain the rural economy. But even in the best of times for agriculture, farm-level profitability, while remaining crucial, cannot by itself support the full weight of rural development. Consider, for example, that an increasing fraction of farm families in Kentucky and elsewhere are economically dependent upon the opportunities for off-farm rural employment. And you understand that farm and rural nonfarm economies continue to be ever more interconnected.

Unfortunately, the potential declines, of which there are some signs, in the rural manufacturing sector could make business recruitment a realistic option for fewer and fewer rural communities. In such circumstances, retaining local businesses, creating new local enterprises, and adding value to local products, be they farm products or otherwise, these become indispensable measures for sustaining the local economy. To do this in both rural businesses and farms, we will need to have innovative leadership, as Ms. Legg said, and greater technical assistance to identify new income opportunities and enhance their products and services.

Rather than speak today about specific policy strategies or issues in economic development, I would like to take this opportunity to comment on the general characteristics of at least one promising, very promising, rural economic development initiative in Kentucky.

One Kentucky program taking an integrative and comprehensive approach is the Kentucky Agricultural Development Fund. Unique among the States, Kentucky has invested 50 percent of its share of the National Tobacco Settlement, well over $100 million to date, in programs supporting both agricultural and, therefore, rural development. This massive and innovative program has benefited from the full participation of State government, farm and community organizations like Farm Bureau, the University's Land Grant system, and hundreds, maybe thousands of local leaders. Beyond investing in on-farm profitability and diversification, the Fund has supported projects in value-added and alternative products, agritourism, rural infrastructure, entrepreneurship and leadership development, marketing, and resource conservation. This is surely one of the Nation's most comprehensive and ambitious rural development initiatives.

Complex, multidimensional economic problems demand integrative, comprehensive strategies. And programs like this acknowledge that multiple ingredients must be assembled for economic success: Infrastructure, leadership and entrepreneurship, access to capital, a skilled and productive workforce, access to and ability to use new technologies.

I would be happy to comment more and answer any questions about the ag development programs in Kentucky as time permits, but I want to conclude by touching on the role of organizations like mine, the land grant colleges, in rural economic development.

As many public universities around the Nation, including the University of Kentucky, are mandated to become an even greater force for economic development, a few States are pursuing a new and broader mission for the traditional land grant system of Cooperative Extension and the Experiment Station. This new land grant approach fosters R&D and technology transfer in a wide array of enterprises, including farming, of course, but certainly not limited to agricultural production. So in Kentucky, we are building rural research and extension partnerships in everything from engineering to fine arts. In one major initiative, we teamed up the university medical center, State health agencies, and county extension agents to greatly expand health education and information access in rural areas.

In another multistate consortium, we are working to grow a manufacturing engineering extension service to better support rural factories. And in the planning stages, and perhaps of interest to this Committee, is a project with Kentucky housing. They intend to require high-speed Internet connectivity in all units that they finance. A nongovernment IT firm is committed to creating a specialized web resource system. And the extension service will provide content on family and consumer issues: Health, nutrition, personal finance, and other topics specifically configured for this particular audience.

Our diverse partners in such programs understand the power of a Statewide, county-level extension network for rural development and the ability to connect this network to the University, State, and Federal level information and expertise. So just as the land grant institutions supported the dramatic advancement of the Nation's farming economy in the last century, they can well serve the broader mission of rural economic development in years to come.

I thank you for the opportunity to comment and for the Banking Committee's thoughtful deliberations on this crucial and very challenging topic.

Senator BUNNING. Thank you very much, Mr. Smith.

Mark Haney, would you like to proceed?

STATEMENT OF MARK HANEY
VICE PRESIDENT
KENTUCKY FARM BUREAU FEDERATION

Mr. HANEY. Thank you, Mr. Chairman.

I again thank you for the opportunity to represent my fellow Farm Bureau members to speak on the current status of the agriculture community and rural America. And thank you for allowing a member of the farm community to be able to come and testify.

We have lots of advantages and disadvantages living in the rural community, but I think the advantages outweigh the disadvantages by a lot. However, I do want to kind of talk about the current status of the agriculture community in rural America and in rural Kentucky.

We came off of kind of a tough year in 2002 for a variety of reasons, one being weather related. Net farm income was off from about $45 billion down to about $30 billion. Farm policy was in transition. Falling grain prices were part of the factor. And that $15 billion loss not only hit farm families in rural America but also hurt small businesses, lending institutions, and made for a somewhat sluggish economy.

That was not necessarily all the things that contribute to maybe sluggish conditions in the rural economy in America, and you will, I guess, hear somewhat of a common theme among the panelists today. Some of the things that I mentioned they have also.

It is very important that we in rural America have communications, telecommunications in particular. We find ourselves sometimes in need of better communication facilities. We struggle to deal with the new infrastructure in rural America for telecommunications, specifically broadband Internet service, cellular towers. We need cellular towers in rural America almost as bad as we need four-lane highways. We desperately have to have communication.

We also find ourselves a bit behind in physical infrastructure. We read about many State legislatures coping with economic woes, and we find ourselves in rural America with bridges and highways in constant need of repair. We have to have the physical infrastructure to get our crops to market, do the things that we really have to do to be able to market the crops that we grow.

To keep a highway system going, it is constantly—we have to do that on a continual basis, and we cannot take breaks in that because there is a need of economic input.

We also find ourselves in rural communities dealing with other topics like solid waste. It can be a real problem. Trash pick-up is not really a luxury in rural America, but it is a problem. We have trash just like everyone else. I live in an area in southern Kentucky, or southeastern Kentucky somewhat, where we are really fortunate. We have Congressman Hal Rogers and his PRIDE program that is making tremendous gains in this field. He is restoring pristine waters to our community. We are able to clean up dumps, illegal dumps, health hazards, all the things that need to be going on, inspiring people with a feeling of pride in their daily lives. I think if we could do that on a national basis, similar type programs, I think it would be very, very good.

Another problem we have in rural Kentucky is not necessarily just our problem, but it is a real problem in rural Kentucky, and that is affordable health care. Rural Kentucky is made up of small businesses, and being a farmer, I consider myself a small businessman. I have a brother that is a partner. We operate a 450-acre farm that has been in our family for more than 130 years. We have fifth generation living on our farm right now. Health care is a problem for everyone, especially small businesses. Small businesses make up most of rural America, and it is a problem for them to provide their family with affordable health care, much less their employees. So, we find that that is a real need in rural America.

Also, we find that long-term care for our seniors is a big problem in rural Kentucky. In my county, I have people that I know personally that have a senior family member that maybe has to be in an institution in a different county, maybe two or three counties away, as much as maybe 100 miles, to be able to house that individual. I think that is a real problem, especially if we want to keep people living in rural America, living in rural Kentucky.

We do have an advantage, I think, in rural Kentucky. Most of our assets are fixed assets. Our savings are invested in fixed assets—land, buildings, equipment—not necessarily so much in the market that you spoke about, the stock market or in equities. So even though we may be slow to gain wealth in rural America, we are slow to lose wealth though. Those farms, those buildings, are there for generations, and they provide stability in our people, in our citizens. I think that is one of the biggest pluses that we have in rural America.

To keep people involved in agriculture, to keep people involved living in rural America, I think we need to make business advantageous to small businesses. That is what, in my opinion, is going to keep people living in rural America. Where we live, where I live in particular, there is a lot of off-farm income that allows people to operate small family farms and have a way of life in a rural setting. I think that is a very positive thing, and I think that is a thing that we need to strive.

One other comment that I would like to make deals more in particular with Kentucky agriculture. Kentucky is made up of a high number of small farms. Kentucky is the fourth largest State in the number of farms. However, our farms are small farms. In Kentucky, the average size of a farm is 150 acres. The national average is about 430 acres. But what has been able to sustain those small farms has been tobacco. For pretty much of the 20th Century, the tobacco warehouses, tobacco auction markets were as prevalent throughout the small communities in Kentucky as post offices were. It has just been a tradition and a way of life.

However, we find that it is beginning to change. Because tobacco is a management system, we have a quota. And we find the quota beginning to shrink. The quota from 1997 was over 700 million pounds. The quota for 2003 is about 290 million pounds. So, we can see how many people are actually getting out of the business or, more specifically, trying to stay in until they find stability in what the tobacco market is going to be.

In the last few years, we find quota lease prices going from 25, 30 cents a pound to—it is not unheard of to hear 60, 70, 80 cents a pound for people to be able to purchase quota or lease quota just to be able to maintain in the tobacco industry until they see what is going to happen.

So there is talk of a buyout that we in Kentucky are very much in support of. We think it will give stability to the people that want to continue in the business. Many, many farms are waiting to find out what they can do. They are in a transition period right now. They are ready to transition the farm, the family farm into the next generation, but they are waiting for the buyout. Not only will it help the farm economy, but it will also have a nationwide health benefit if it is tied to the FDA's regulation of tobacco products.

If there are any questions about the buyout or anything about Kentucky agriculture, I would be happy to entertain those. Again, I want to thank you for the opportunity to come and testify today.

Senator BUNNING. Thank you, all three of you, for your testimony. We will have just a few questions for you. Not too many.

Ms. Legg, in recent years, the number of employees that telecommunicate to work has been on the rise. Employees are able to work from their homes and avoid the long commutes and higher prices of living that occur in cities. This being said, there has still not been a lot of employees migrating to rural areas to take advantage of this telecommunications. What can be done to notify more businesses and telecommunicators to the benefits of rural America and add other value-added enterprises to farms?

Ms. LEGG. That is an excellent question. I think what it is going to take is a combination of efforts.

First of all, the high-speed connection has to be there, not just Internet access, because if you are really going to do business from home, the dial-up modem, which is the most prevalent accessibility of Internet is not competitive. If you are doing business in a global marketplace, you have to have the high speed.

We have at USDA in our rural development program a broadband program to try to build out that infrastructure, as Mr. Haney mentioned, to try to get high-speed access into those rural communities. But as in any program of economic development in rural America, it is economies of scale. How does the private sector build out in a more densely populated area and have enough take rate, if you will, to pay back a loan, even a low-interest, Government-backed loan? So, you have to look at the economies of scale.

What I think we have to do, the number one thing, is to help drive the market, help to create the awareness of what that high-speed connection can do. As you pointed out, telecommuting, members of your business working from home, yes, that is somewhat of a culture shift from some of us that are much more traditional workplace-bound. But that is why it takes leadership. That is why it takes education. It is the awareness of what that connectivity can do for your business or for you as an individual if you are allowed to work at home.

So it is a combination. We do have to have financial resources, but we almost have to have a willingness to change the way we have traditionally approached many aspects of our life in order to recruit that. And then I think we have to do maybe a stronger emphasis on the whole aspect of business development because if you are going to sustain job growth and retention in rural America, it is going to be your small- to medium-size businesses, by and large, for long-term stability. Mr. Haney mentioned five generations. It is doing that kind of thing.

I think the emphasis has to be on some entrepreneurial aspects within our culture, how you can make a living in rural America, but you must have that infrastructure capability to connect you to the global marketplace. And we have examples of how we try to do that and are doing it with our rural development programs. But, again, it comes back to the business piece of it as well, being able to repay those investment loans.

Senator BUNNING. To follow up, how do we convince our small entrepreneurs and our small business people to buy into that type of set-up? Because if I want to live in Somerset or if I want to live somewhere in rural—and I do not consider Somerset rural—it is one of the major cities in Pulaski County, maybe the largest city there. But if I wanted to live in Inez in Martin County—and that is rural—how do we convince an entrepreneur to buy into the fact that people actually can perform valuable work through high-speed Internet connecting and they do not have to report to work every day to do it?

Ms. LEGG. And that they will be actually working.

Senator BUNNING. That they will be. I mean, you can check on the connection.

Ms. LEGG. It really is a culture shift, and what we have to do, again, I was appreciative of Dr. Smith here talking about the leadership. We have to lead by doing. You are doing that by presenting this public forum. We have to get out there and—actually what I call the three A's of technology: First, just to be aware of what it is, which many of our rural residents still do not know what "Surfing the Net" is; and, second, we have to have access—that is the infrastructure; and the third thing it has to have is application. It has to be applicable. It has to make business sense. We, as a whole, I think, have to do a better job of how we educate our businesses and our entrepreneurs about how it makes their business more efficient if they have telecommuting employees or if they have high-speed bandwidth and do global marketing. It is a matter of demonstrating that.

And through some of our rural business development programs at RUS and certainly through some of our marketing efforts with the rural utilities program, we are trying to get that—it is about the application and the business advantage. It is like the old REA I use all the time the analogy of. When we first began to put electricity, if you were used to baking on a wood stove—you may not have ever done that, Senator, but I do remember that in my household. You did it, chopped the kindling. It was a part of your daily activity. Your recipes were geared to baking on a wood stove. Why did you need to buy a new stove? Why did you need to do this? Why did you need a monthly electric bill? Your life was going on pretty much the way it was. But we went out at the old REA and actually did demonstrations. They took the circus on the road. They showed housewives in rural America how to use an electric stove or an iron or washing machine. It was a huge cultural shift.

I do not think that analogy could be lost in today's technology. How do we help people learn how it helps them make their lives and their businesses better?

Senator BUNNING. Dr. Smith, you mentioned some things that the extension program was getting into. Can they also get into this type of educational program that I was just speaking about?

Mr. SMITH. Yes, absolutely. And, in fact, some initial efforts have been made, not just in Kentucky, but also in other States. Ms. Legg mentioned entrepreneurship, and we believe that entrepreneurship can be cultivated and taught. There are programs in Appalachian Ohio which focus on entrepreneurship development that are partnerships of the State government and the extension service. We have a small program that is about to start in the Morgan County, Menifee County area, around the IT Center in Morgan County, that focuses on development of an entrepreneurial nucleus in those counties and building the networks, providing them with the information resources. And as part of that, building the awareness and the access to that culture of leadership and entrepreneurship.

I think that it is a very important opportunity and responsibility of the extension service, of the community and technical college system, and of State government and the Federal Government as well. The development districts and others, small business development centers can all be a part of this, and they all need to be. But extension, because of our trusted position in every county seat has a unique role to play, and we intend to begin exploring that opportunity.

Senator BUNNING. Mr. Haney, you mentioned the tobacco buyout, and I want to pursue that to a degree. The tobacco Senators here in the U.S. Senate have been meeting off and on since the beginning of this session, trying to come up with some kind of viable piece of legislation. And we keep running into the same problem. How are we going to pay for it? I think we can solve the problem of the buyout if we can find the dollars to do it.

Does somebody from your community and/or your organization have an idea where we can find the dollars to—now, I do not want to get back to Phase 1 and Phase 2 because that is ancient history and it is water over the dam. We had an opportunity 5 years ago, and some of our leading spokesmen for buyout at that time—Senator McConnell said do not leave this on the table. Unfortunately, everybody in the farming community thought that the quotas would not be now 40 percent of what they were at that time, and that is about where they are at.

Can you advance some type of system where we can go to buyout at the levels that we have talked about, 12 and 8, and take care of everybody that is involved in growing burley and dark-leaf tobacco in Kentucky?

Mr. HANEY. Yes, sir, I think—you mentioned the 8 and 4, and I think that is kind of stuck in rural Kentucky. Anywhere you go in the State of Kentucky or most any tobacco State, they are talking about $8 and $4 being the value of the quota, depending on if you are a quota owner or if you are a grower.

I personally do not see any way to have a quota buyout without it being tied to FDA legislation. I know that some people would like to think about other ways of doing that, and, of course, we are open to talk about it anyway. But we think FDA legislation is probably the most legitimate way to fund this, and it would be a user fee, an assessment on the product, all tobacco products, not just a few but all tobacco products sold in the United States.

Senator BUNNING. And part of that you think can be sold because those who fought us so vigorously in the past as far as growing tobacco would be amenable to the buyout because of the FDA's involvement in the controlling of that growing on the farm? Is that why you think that they may be willing?

Mr. HANEY. Yes, sir. I think there is a lot of people that have been opposed to tobacco production over the years that would like to see Federal regulation of that industry or especially those products. I guess with the entrepreneurial spirit of rural America and many farmers that I know, when you have somebody really wanting to have Federal regulation of tobacco, and there are people that really need a tobacco buyout, then I think it is time to sit down and talk and maybe negotiate.

Senator BUNNING. Let me ask you the question that constantly comes up in our meetings. Do farmers in Kentucky and in the other tobacco States expect to have a program that is still there to back up after a buyout occurs?

Mr. HANEY. I think there is a need for not the program per se that we have right now. I do not think anyone says that the program that is existent is the one that we need in the future. It is not exactly filling the need right now, and that is the need for some change.

However, I think there is a need for a structure, some structure of the industry, especially through a transition period. I just cannot hardly describe what tobacco and tobacco production, the importance it plays in rural Kentucky, especially, Senator, in the northeastern counties of Kentucky.

Senator BUNNING. You do not have to. I used to represent all those counties.

[Laughter.]

Mr. HANEY. I know that, sir. And even in eastern Kentucky and where I live, it is very important to a lot of people. Now, I know you think maybe I live in urban America, but I really do not. Somerset is a nice size town, but I live out in a little town called Nancy, agriculture-based. I have been in the fruit production all my life, and tobacco has been grown in my family for years and years and years.

However, where we live in Kentucky, light industry is now there. The medical industry is a huge employer. People are able to have off-farm income, not necessarily dependent upon tobacco production. We live in a community that is so fortunate to be able to do that. But as you know, most communities, especially in eastern Kentucky, where small farms are there, no industry, those people are so dependent upon the tobacco production. So for at least a transition period—we all know that tobacco production is down and going to stay down. Domestic use is on the decline, and domestic purchasing is on the decline. We see the handwriting on the wall. But we do need help in a transitioning period.

Senator BUNNING. Dr. Smith, do you see the conversion of the rural economy from—I will give you an example. Robertson County is 85 percent dependent on tobacco; Mason County that I represented is right around 80 percent dependent on tobacco. Do you see the ability of our rural counties in Kentucky to convert, bring in small business people and have those entrepreneurs that you are talking about take at least a portion of that economy on rather than the—believe me, I understand the grip and the heritage that was brought from Virginia to Kentucky at the beginning, and that heritage is still there on growing burley tobacco in Kentucky and other kinds of tobacco products. But do we have the ability?

Mr. SMITH. Yes, I believe we do. I painted a fairly negative picture of nonfarm employment in rural America, but opportunities remain. And throughout most of the 1990's, nonfarm employment in rural areas was a success story through rural manufacturing and other enterprises.

Counties like the ones you mentioned have to diversify. Regardless of the outcome of the tobacco programs and tobacco production in those areas, they will either become commuting locations where people go to Cincinnati or northern Kentucky for jobs, or they will find ways to diversify. And I think they have many opportunities: Small businesses, different agriculture and natural resource-related opportunities. Forestry and value-added timber production is a developing success story in parts of eastern Kentucky.

There are opportunities like that in many parts of the State. There will be no single answer that works for each location in each geographical area. It will depend very much on the entrepreneurship, the leadership, and the initiative coming from those homegrown enterprises. I think that we cannot emphasize enough the importance of not relying totally on recruitment of outside businesses, that we have to grow our own in Kentucky and encourage and support those counties as they attempt to do.

Senator BUNNING. I have just been informed that the Federal Reserve lowered the Fed fund rate by one-quarter of a point. Unfortunately for us, it should have gone 50 basis points instead of 25. But Alan Greenspan is not right all the time.

[Laughter.]

Let me ask, and you brought this up, Mr. Haney, about prescription drugs and health care for our seniors in rural Kentucky and rural America. We are working on a bill, as you well know, that will for the first time in over 30 years do something to Medicare that will allow a prescription drug benefit to be added to not only Medicare Part B, but also we will have other options. They will all be private sector options, and it will give what I consider a generous benefit to the neediest of the needy in not only Kentucky but all over this country. From 160 percent of poverty down, the most we will charge, starting in 2006, is a 10 percent premium. That is all you will have to pay, down to 2.5 percent if you are in the 100 percent of poverty to 74 percent.

If you are below 74 percent, Medicaid will have a wrap-around that will pick up those prescriptions for $1 and $3. That is all the cost that the poorest of the poor seniors will have.

One thing I want you to know, we have looked at long-term care, and that is the real bogeyman, or whatever you want to call it, because of the cost to whoever is footing the bill, whether it be the State government, local government, Federal Government. The cost of long-term care, as you well know, is footed by Medicaid in some instances right now to a degree, but generally by the individuals that are supporting the person that is in long-term care, the family.

We do not have a solution for that right now. We are looking for solutions. We are even looking at what we call tax incentives, to incentivize in the Tax Code the ability to buy long-term care and have it pretaxed dollars. In other words, if you pay for it, you do not have to pay income tax on the dollars you spend on Medicare or for long-term care for your family member, whether they are a senior or whether they are not. Some people are not always senior when they go into long-term care. We have quite a few people, in fact, that are not senior citizens. However, generally speaking, they mostly are.

We hope we can get that job done. I know we are going to get the Medicare prescription drug bill out of the Senate on Thursday evening of this week, unless some catastrophe befalls us, and we will get it out of the House sometime Friday morning by 3 a.m. or 4 a.m., and we will get it to conference. And that is where the sticky part starts to get a bill that we can bring out of conference and everybody can continue to vote for.

Presently, I think we have about 80 votes in the Senate or up to 80 votes for the bill that is on the floor. And I think it is very important to our seniors to understand what we are trying to do. You brought that out, and I thought I would just mention that.

I appreciate you all coming because rural America sometimes gets left behind and left out, particularly as far as economics is concerned. They have been there forever. They did their thing the same way, and they are the hardiest of the hardy. The salt of the earth are the people that live in rural America. And in Kentucky, we have an unusually large portion of our families that live in rural America. Your ideas and your thoughts on this subject are deeply appreciated.

Thank you all for coming. This hearing is adjourned.

Ms. LEGG. Thank you, Senator.

Mr. SMITH. Thank you.

Mr. HANEY. Thank you very much.

[Whereupon, at 2:50 p.m., the Subcommittee was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF HILDA GAY LEGG

ADMINISTRATOR, RURAL UTILITIES SERVICE
RURAL DEVELOPMENT MISSION AREA
U.S. DEPARTMENT OF AGRICULTURE

JUNE 25, 2003

Chairman Bunning and Members of the Committee, thank you for the opportunity to participate in this hearing, "The Economy in Rural America," the second in a series of hearings entitled: "Jumpstarting the Economy." You are to be commended for this careful and thoughtful approach to creating a public forum for both understanding the problems and the challenges that we face and seeking answers to those challenges.

As Administrator of the Rural Utilities Service and as a part of the USDA Rural Development team, I work with our programs that provide financing for infrastructure construction for electric power, telecommunications, and water and waste disposal services. I come from a background that includes building economic development in Kentucky and working with the Appalachian Regional Commission. The programs of the Rural Utilities Service are just a part of the Rural Development mission area that also finances Rural Housing, Community Facilities, Rural Business and Cooperative Services programs.

Our focus in the Rural Development mission area is to help rural areas achieve economic and social gains that are solid and long lasting. When you are working to build jobs and economic development in small rural communities, you are always looking for the home run that brings in hundreds of new jobs. But we must be mindful that quite often, the long-term gains are made with adding a few jobs to a small business or helping local business leaders target industries that add value to the existing community.

The Federal Reserve Bank of Kansas City's Center for the Study of Rural America reports in their May Overview, that the rural economy continues to hold steady, with rural jobs growing slightly by 0.7 percent in February compared with a year earlier. Job growth is increasing at a slightly higher percentage in rural areas compared to job growth in Metropolitan areas according to the Bureau of Labor Statistics. The overall economy appears to be gaining strength, and unemployment in both metro and nonmetro areas can be expected to decline as growth picks up this year and next year.

While no one is claiming we are in a boom cycle again, it appears that the rural economy is heading in the right direction. President Bush's initiatives on tax cuts, business growth, and energy are all a vital part of this equation.

There are a number of things that can be done to help stimulate rural economic growth. There is no one answer for fostering rural economies because like the rest of the Nation, rural America is very diverse. Rural America is an eclectic mix of races, ethnic groups, terrain, climate, amenities, businesses, and institutions. While agriculture is certainly prominent, no one industry dominates the rural landscape, nor does a single pattern of population decline or growth exist for all rural areas. Diversity presents opportunities for creative answers and unique partnerships.

At the beginning of the 21st Century, according to the U.S. Census and the USDA's Economic Research Service, rural America comprises 2,305 counties, contains 80 percent of the Nation's landmass, and is home to 56 million people. Seven out of eight rural counties are dominated by manufacturing, services, and other employment not related to the production of food and fiber.

In Secretary of Agriculture Ann Veneman's book "Food and Agriculture Policy," published last year, it is pointed out that despite seven out of eight rural counties being dominated by nonfarming activities, this in no way diminishes the importance of ranching and farming in many rural areas. However, in many communities, this diversity provides a strength that will hold up in times of too much rain or not enough rain.

The economic resources of many rural communities draw from three basic assets: Natural attractions for tourism and retirement; low-cost, high-quality labor and land for manufacturing; and natural resources for farming, forestry, and mining. This is quite different from a half a century ago when a quarter of our population was engaged in farming and ranching.

The role of the Rural Development mission area of USDA is to provide an effective set of tools to help these diverse rural communities improve their economic growth. One challenge we face is infrastructure. On the national level, we have seen a serious downturn in infrastructure development, especially in the telecommunications field. In more urban areas, there was a great deal of "dark" or unused fiber optic laid with the belief that "if you build it, they will come." On the other hand, very little dark fiber exists in rural America.

The fact is we had to relearn an old lesson, that a good business plan is necessary, no matter what the technology. High-speed telecommunications services are mandatory for new jobs for not only the future, but also today. Just like a good road, fiber optics requires a use for it to be beneficial to add to economic structure of a rural area. There is no doubt, without that infrastructure being built, "they will not come!" Modern infrastructure is necessary to bring in many things that are needed: Businesses, quality housing, modern schools, quality health care, dependable electric power, safe drinking water, and ecologically sound waste disposal. In the same manner, without houses, businesses and strong communities, there is no need for modern infrastructure. Just to install broadband telecommunications capability without a plan for its use, it is high stakes rolling of the dice.

Rural America finds itself in the midst of a revolution of change in the areas of telecommunications and electric infrastructure. The Telecommunications Act of 1996 has created an interesting and complicated landscape. Many of the larger providers have chosen to place their resources in the more densely populated areas of the country. But we see a vast number of entrepreneurs, from the small traditional telecommunications companies to new start-up businesses, stepping bravely into this new and hopefully competitive marketplace. The general investment community is very hesitant today to finance any telecommunications development needs, and this has made our job at the USDA far more challenging. We want to provide funding for high-speed telecommunications development, but we also want to continue our history of high-quality loans that are a good use of taxpayer dollars entrusted to us by the Congress.

Today's high-speed telecommunications offer as much new opportunity to rural communities, businesses, schools, and health care facilities as the availability of electric power and telephone service did some half century ago. Along with this infrastructure is the need for high-quality education. If rural America is to continue to provide a high-quality workforce, a base of customers with good incomes, then educating and training that workforce is vital to economic development.

We are seeing examples of economic development that is making a difference in the lives of rural citizens. When Secretary Veneman and Under Secretary Tom Dorr announced the new Broadband Loan program this January, we heard testimony via telecommunications video conferencing with a businessman and a farmer in Kansas as to what the availability of high-speed technology meant to them.

For Osborne Industries, a local agricultural services manufacturing company, a high-speed connection better enables them to manage and market their products competitively in domestic and international markets far from Osborne, Kansas. The local farmer told how he was not only better able to follow markets and weather information, but also his wife was able to further her education through telecommunications without long drives and time away from her family. Use of telemedicine is bringing improved quality health care that is often life saving to rural citizens.

Clean, safe drinking water and ecologically sound waste disposal is an equally vital aspect of both rural health needs and quality of life for rural citizens. There is no more basic human need than clean, safe drinking water. USDA, through the Rural Utilities Service, provides loans and grants to over 8,000 small municipal and rural water systems. If you are going to recruit a business to a small community, the first question they will ask is in regard to the availability of water and waste infrastructure. If the business involves manufacturing, the need is ever greater.

We see the development of renewable energy not only to improve the availability of energy to rural residents, but also as a rising economic opportunity. The future development of "power farming" will be a new crop in many cases for farms and rural residents. Ethanol, solar, and wind are the most economically competitive energy sources at this time, but development of bio-energy projects continues to improve the economic future for farms and rural businesses. Use of traditional farm crops such as soybeans and corn for industrial bio-products will increase the demand for those crops over time.

The challenges remain. Some areas of rural America are seeing population growth and with it, economic development. Other areas, such as the Great Plains and parts of Appalachia continue to experience out-migration. This places strains on local economies and under cuts the tax base for local and State government. Many of our Native American tribal reservations, as well as other pockets of other rural areas, still face high unemployment and poverty, coming from isolation, lack of infrastructure, and the need for innovative leadership. As a Nation, we are as strong as our weakest link. Low percentages of unemployment sound a little hollow to that person that is unemployed. That person's unemployment level is 100 percent.

It is always easy to look at national numbers and percentages, while forgetting the individual needs of rural citizens and communities. USDA, like any other Federal agency, does not have easy answers. We do find that by working with our rural partners of community leaders, we can make gains in rural communities and that turns that big ship in a different direction, one degree at a time. The USDA Rural Development field staff, in State and local offices, still serves as our front line in working directly with rural leaders for stronger communities.

Building quality infrastructure, housing and businesses based on long-term plans and good business models makes an economy grow. Local leadership and citizen commitment is a key ingredient to making these programs work.

In an article in the *Economic Review,* First Quarter of 2003, Jason Henderson and Nancy Novack do a good job of summing up what must be done in rural areas for economic growth to occur. "To compete in the future, rural industries will need to be innovative in finding business solutions that go well beyond low-cost land and labor. Success will depend on management skills in addition to production capabilities. New products will need to be developed. New technologies will need to be adopted to increase production efficiencies and create a new competitive edge for rural industries."

This will require strong education to be available to keep up with a changing world. It will require available capital for business development. And it will require strong rural leadership to make these things happen at the local level. Partnerships with other local communities, on a regional basis, and often with the larger metropolitan areas will be key in rural economic growth of the future.

I appreciate Chairman Bunning's leadership and the support of Congress as you work to continue to make rural America a strong and vital place to live and work.

Thank you.

PREPARED STATEMENT OF M. SCOTT SMITH

DEAN AND DIRECTOR, COLLEGE OF AGRICULTURE, UNIVERSITY OF KENTUCKY

JUNE 25, 2003

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to share these remarks on rural economic development. I serve as the Dean of the University of Kentucky's College of Agriculture and the Director of the Kentucky Cooperative Extension Service. Rural economic issues largely define the mission of our organizations.

Rural counties and small cities in Kentucky, and throughout the Nation, face daunting economic challenges. The recent economic slowdown compounded with significant changes in agriculture are threatening job and income security. The current economic climate has had a particularly negative effect on rural areas compared to metropolitan areas, and on rural economies like Kentucky's compared to the rest of the United States.

- Nationally, manufacturing employment from 2000–2002 has declined 10.1 percent in rural areas, compared to 7.3 percent in metro areas. (Drabenstott, 2003)
- The rural service sector is also struggling to maintain employment.
- Rural construction activity is slow.
- And rural recreation and tourism has not fully recovered from 9/11.
- On top of this, in tobacco states like Kentucky, the shrinking quota and the changing program will continue to have dramatic effects, not just on farmers but on entire rural communities.

Although the farm economy was generally described as recovering in 2001 and 2002, much of this advance was due to transfer payments. We all appreciate the uncertainty and undesirability of relying on farm programs to sustain the rural economy. However, even in the best of times for agriculture, farm-level advancement, while remaining crucial, cannot by itself support the full weight of rural development. Consider that an increasing fraction of farm families are economically dependent upon off-farm rural employment opportunities. Farm and rural nonfarm economies are more than ever interconnected.

Unfortunately, declines in the manufacturing sector could make business recruitment a realistic option for fewer and fewer rural communities. In such circumstances, retaining local businesses, creating new local enterprises, and creating new sources of local income become indispensable to improving the local economy. To do this both rural businesses and farms will need greater technical assistance to identify new income opportunities and enhance their products and services.

Integrative, Comprehensive Strategies

Rather than speak about the specific policy strategies or the economic issues in rural development, I would like to take this opportunity to comment on the general characteristics of at least one promising rural economic development initiative in Kentucky.

Complex, multidimensional problems demand integrative, comprehensive strategies. Multiple ingredients must be assembled for success: Infrastructure, leadership and entrepreneurship, access to capital, a skilled and highly productive workforce, access to and ability to use information age technology. Service, manufacturing, Government, and farming sectors all have to be considered. New bridges between new partners will be essential.

One Kentucky program meeting this description is the Kentucky Agricultural Development Fund. Uniquely among the States, Kentucky has invested 50 percent of its share of the National Tobacco Settlement, well over one hundred million dollars to date, in programs supporting agricultural and rural development. This massive and innovative program has benefited from the full participation of State government, farm and community organizations, the University's Land Grant system and hundreds of local leaders. Beyond investing in the on-farm profitability and diversification, the Fund has supported projects in value added and alternative products, agri-tourism, rural infrastructure, entrepreneurship and leadership development, marketing, and resource conservation. This is surely one of the Nation's most comprehensive and ambitious rural development initiatives.

Broadening the Land Grant Mission

Finally, I want to touch on the role of organizations like mine, the Land Grant colleges, in rural economic development. As many public universities around the Nation, including the University of Kentucky, are mandated to become an even greater force for economic development, some States are implementing a new and broader mission for the Land Grant system of Cooperative Extension and Experiment Station research. This new Land Grant approach fosters research and development and technology transfer in a wide array of enterprises including, but certainly not limited to, farming. In Kentucky, we are building rural research and extension partnerships in engineering, health, business management, and even fine arts. Our diverse partners in these areas understand the power of the Statewide, county level Cooperative Extension network for rural development and the connection of this network to University information and expertise. Just as the Land Grant institutions led the advancement of the Nation's farming economy in the last century, they can serve the broader mission of rural economic development in years to come.

I thank you for the opportunity to comment and for your thoughtful deliberations on the crucial and challenging issue of rural economic development.

PREPARED STATEMENT OF MARK HANEY

VICE PRESIDENT, KENTUCKY FARM BUREAU FEDERATION

JUNE 25, 2003

Mr. Chairman and Members of the Subcommittee, I appreciate the invitation to make brief comments on the status of the rural economy to the Subcommittee on Economic Policy. My name is Mark Haney, I am Vice President of the Kentucky Farm Bureau and I am also a Board Member on the Monticello Banking Company-Somerset Bank. I own and operate a 70-acre apple and peach orchard in Somerset, Kentucky, where we manufacture and market our own value-added frozen apple pies. My farming operation also entails 90-head cow/calf operation and a 38,000 pound tobacco allotment. Somerset lies in southeastern Kentucky.

I am excited that the Members of the Subcommittee chose to have a separate hearing on the status of the rural economy. Because rural America enjoys different advantages but also different challenges in building a vibrant economy.

Let me briefly mention the current status of agriculture since the well-being of rural economies depends so heavily on that sector. Because of poor crop yields and shifting farm policy, farmers are coming off of a very difficult year in 2002, in which U.S. net farm income fell from $45.7 billion dollars to $30.2 billion dollars. Please consider that this total loss of $15.5 billion is not just a loss to farm families but also to many rural financial institutions.

Fortunately, economic aspects of the 2003 crop year seem to be looking up on a national scale. Since this point last year, grain prices have been on the rise. Last month's projections estimate that U.S. net farm income is expected to rebound 53 percent to $46.2 billion in 2003. While this short-term increase should make many bankers smile, please consider that it is an increase to already unacceptable levels we have seen in the last decade.

While agriculture is one segment of the rural economy that is not thriving, other factors are contributing to its current sluggish conditions. First, rural America is struggling to equip itself with the Nation's newest form of infrastructure, telecommunications. In this era, access to broadband Internet service and mobile cellular towers is nearly as important in securing jobs and recruiting business as four lane roads. Many State legislatures are considering programs to enhance the ability of rural residents to gain greater access to telecommunications, but while we wait, large businesses find it a difficult choice to locate in rural areas.

Second, the physical infrastructure of rural America needs improvement. While State legislatures deal with slumping budgets, improvements to roads and bridges wait. Proponents of many worthwhile new projects are being told to wait for years until economies balance. Examples such as weekly garbage collection, animal removal, and maintenance of roadside vegetation that seem insignificant to most Americans is not available in many rural areas. Eastern Kentucky has placed great emphasis on maintaining the environment through the leadership of Congressman Hal Rogers and his PRIDE program. With this project, we have done a good job of cleaning up unsafe dumps and litter. I think that we need to consider a greater nationwide focus on these kinds of ideas.

Last, the lack of availability of affordable health care plagues rural communities, but I know that rural America does not suffer from this alone. Rural America is built on small business that often cannot afford group policies to insure their employees. The Kentucky Farm Bureau strongly believes the Associations Health Plans legislation that recently passed in the House will help to remedy this burden. Also, I think we must pay attention to the lack of adequate long-term care for seniors; since outlets for special needs assistance in nursing homes are sometimes hours from rural communities.

Despite burdens that make it difficult for rural economies to be vigorous; rural areas do have some advantages not provided to our urban friends. Rural investments tend to be more stable than the fluctuating stock market more commonly used in urban areas. Rural Americans typically have their savings tied to fixed assets such as land, buildings, and equipment. In other words, we do not get rich quick but we do not get poor quick either.

The sense of community in rural America helps its residents endure tough economic situations. The hard times do not come and go as often in rural areas but stay longer when they hit. Although agriculture can be a very competitive business you will frequently see farmers working together to help each other get their crops planted or harvested before seasonal deadlines hit. The entrepreneurial spirit is also creating new ideas and strategies for enhancing economic development through tourism and other value-added businesses in rural communities across the United States.

Finally, our natural resources provide us opportunities not granted to urban areas. From coal in the Appalachian region to oil fields in the southwest, but most obviously the fertile land from which we derive the world's food supply, our resources provide the backbone for our economies. That is why it is evermore important to be mindful of the impact unreasonable environmental regulations can have on rural America. What works for downtown Philadelphia, Pennsylvania, does not always work for Inez, Kentucky. Some environmental regulations can strip rural communities from the staple of their economies.

Please allow me one minute to mention an issue that is of utmost importance to the rural economy in Kentucky and other States in the Southeast region of the country. The status of the tobacco industry is in complete disarray. Tobacco, historically, the States largest cash crop has had a profound effect on the State's rural economy. Kentucky is a rural State. And agriculture is the largest economic contributor to the State's economy. According to most recent statistics, 13.6 of 25.4 million acres, or 53 percent, is declared farmland. The average farm size in Kentucky is 155, compared to the same national statistic of 436. These numbers indicate Kentucky to be a very small-scale agricultural State. Kentucky ranks fourth in the United States in total number of farms. All characteristics of Kentucky's agriculture—size, scale, and frequency of farms—is largely influenced by a strong reliance on the production of tobacco.

Kentucky's geographical characteristics, climate, and soil types; especially in the eastern portion of the State, are an ideal match for the very specific requirements in the production of the crop. Throughout Kentucky's history, the production of tobacco has been the strongest financial resource to a vast majority of rural communities throughout the Commonwealth. For most of the 20th Century, tobacco markets and warehouses were as prevalent as U.S. Post Offices in the downtown areas of rural Kentucky.

Rural communities in Kentucky are currently witnessing a dramatic revolution. Due to a variety of factors, the demand for tobacco has decreased from 704.5 million pounds in 1997 to 289.5 million pounds in 2003. This is a 59 percent decline over 7 years. Since tobacco production operates within a supply management, quota system, lease costs have skyrocketed from a 26 cents per pound average to a 62 cents per pound average over a similar time period. Current concepts for Federal legislation can take a large step in helping stabilize the tobacco industry and thus rural economies throughout the Bluegrass State. It would give farmers the resources to retire or venture into more promising industries while still being able to remain in the rural areas that they were born and raised in. Tobacco buyout legislation will not only help our economies but also can have a nationwide health benefit if it is tied to the FDA's regulation of tobacco products. I will not spend anymore of your time on the details of tobacco buyout legislation, but I encourage you to work with the Senators from tobacco States who will most assuredly be contacting you about this issue.

Thank you again, Mr. Chairman, for the opportunity and for taking an interest in rural areas. I look forward to answering any questions you or the Members of the Subcommittee have.