

Testimony Prepared for the Subcommittee on
Domestic Monetary Policy, Technology and Economic Growth
of the
U.S. House of Representatives
Committee on Financial Services

March 29, 2001

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Summary

After experiencing one of the best and longest expansions ever in US economic history, the economy slowed in the third quarter of 2000. While policymakers were looking for and wanting a moderation in growth, the slowdown has been sharper than expected in recent months. While areas of economic weakness are evident, the strong fundamentals of low unemployment and inflation remain in place, and the chances are good that an outright recession will be avoided. Slow growth is likely this year but normal growth should resume after that, even if there were no tax stimulus package.

Monetary policy is the first and most effective way to avoid or to combat recession and the Fed has acted quickly to lower rates. It may need to take further steps to lower rates if the weakness continues. Monetary policy is the best policy to get us back on track.

Past history suggests that manipulating taxes in order to stabilize the economy is rarely effective and can be harmful. More importantly, we must keep in place the policies that contributed to the outstanding economic performance of recent years. 1. The policy of fiscal discipline—shifting from deficits to surpluses--paid off handsomely and must be sustained. This requires that the future path of discretionary spending must be forecast realistically, and the uncertainty in revenue projections recognized. 2. The budget surpluses that fiscal discipline have generated provide a unique opportunity to meet the challenges of Social Security and Medicare reform. 3. The US must move over time to reduce its trade and current account deficits. To do this we must, as a nation, reduce the gap between what we spend and what we produce. Cutting taxes moves us in the wrong direction and makes it harder to solve the trade gap.

Rapid economic growth over the long run requires that we invest in the future. This helps productivity, which then increases wages and family incomes. And it also helps the Federal budget, thereby creating a virtuous cycle. Fiscal discipline is a way of increasing the amount of capital available to the economy and supporting future growth.

A tax stimulus package is likely to have only a modest effect on the current short-term weakness. Any tax cut should be moderate in size; it should be designed to come into effect now. And it should be targeted to low and moderate income families that need help in a softer economy.

But whatever the pros and cons of a moderate tax cut or rebate to stimulate the economy, a very large, long term tax cut that phases in gradually over the coming years is the wrong approach to deal with a temporary economic slowdown.

The latest jump in consumer confidence is welcome, but some families are still nervous. An important reason is that they see the consequences of job loss. Bills cannot be paid and health insurance may evaporate. This is an appropriate time to review Federal programs, like unemployment insurance, that help those who may be hurt by layoffs. Making sure that job losers and their families can avoid financial disaster and maintain access to health care would further increase consumer confidence.

The Current Economic Situation

Real GDP grew at a rate close to 6 percent for the four quarters from mid 1999 to mid 2000. With a labor market that was already tight, this pace of expansion was not sustainable over the long term. The economy had to slow down. There was so much good economic news that stock market investors got carried away. Stock indexes reached levels that were not justified by realistic estimates of future earnings. Some adjustment in the markets was inevitable.

There is no question the slowdown is painful, that many companies, particularly in manufacturing and high-tech, are experiencing wrenching adjustments. Some workers are being laid off. New jobs are scarcer. But Congress should avoid making bad policy in an over-reaction to what is likely to be a short run problem.

The fundamentals of the economy are very strong. The unemployment rate in February was 4.2 percent and the economy was still adding jobs. This unemployment rate is far lower than at any time in the 1970s and 80s. The Dow-Jones index has fallen, but this follows a period of extraordinary increases. Ups and downs in the economy and in markets are inevitable. The miracle is how long the expansion has lasted and how strong it has been, with broadly-rising wages and incomes. It is amazing how much wealth has been created. And the chances are good that the current expansion will continue, albeit at a slower pace than before.

The first line of defense against recession is monetary policy. The evidence of recent history is that the Fed has the power to act quickly and forcefully to rein in an economy that is going too fast, as it did in 1999 and 2000, or to stimulate an economy that is going too slow. And the Fed has indeed acted quickly in response to the changing economic circumstances. But monetary policy takes time to work. It took a while for rising rates to cool off the economy and it will take a while for lower rates to have their full impact. But the economy does have its own recuperative powers. Once excess inventories have been worked off, production turns up again. And there are automatic stabilizers on the fiscal side. Laid off workers collect unemployment insurance. A slowing economy will automatically increase spending for support programs and decrease tax revenues. Budget surpluses at the Federal, State and Local levels will be lower than had been projected, even without any action from policymakers.

The Limits of Discretionary Fiscal Policy

The use of fiscal policy changes to stabilize the economy is based on a simple and valid principle. When consumers are not spending and there is weakness in aggregate demand, tax cuts can encourage spending by increasing after-tax incomes.

Three factors weaken this simple argument for discretionary fiscal policy. First, consumers will likely spend only a part of any tax windfall, particularly if they are worried about future economic conditions. So each dollar of tax cut will translate into

only a fraction of a dollar of extra spending. Second, tax cut legislation has to be enacted and the impact has to be felt in people's after-tax incomes. This all takes time and the effect of the tax cut may happen after the economy has already started to recover and the tax cut is no longer needed. Third, a large tax cut means that the Federal budget will run smaller surpluses or possibly deficits. There will be less revenue to pay down the debt, so that long-term interest rates will be higher, and this will discourage investment spending.

The effectiveness of a tax cut would be enhanced if it gives help to low and moderate income families. Such families need all the after-tax income they can get to provide for essentials and are likely to spend most of any tax rebate. A small tax cut would not undermine fiscal discipline.

The Benefits of Fiscal Discipline and Investment

The U.S. economy has performed extraordinarily well, sustaining strong accelerating growth through the first half of 2000, with low inflation, unemployment close to 4 percent, rising household incomes and declining poverty. This stellar performance was achieved with steady reductions in the budget deficit, followed by strong budget surpluses.

The keys to strong economic performance over the long run lie in rapid innovation, a high level of investment, and a skilled workforce. One sign that the economy performed well in these areas is the rapid rate of productivity growth. From the cyclical peak in 1989 through the third quarter of 2000 output per hour in the non farm business grew at 2.3 percent a year, far faster than the anemic rate of 1.4 percent a year that was the prior trend. Almost all of this improvement took place in the second half of the 90s. From 1995 through 2000 productivity increased by about 3 percent a year. Other signs of dynamism during this period abound. There was a surge in R&D and in the number of patents granted. New firms proliferated.

Economic policy must create an environment in which these conditions can continue. Fiscal discipline alone did not cause this exciting change, but it helped substantially. It kept interest rates low, encouraging investment, contributing to a strong stock market and allowing millions of Americans to afford houses, cars and other durable goods. Moreover, those who argue today that large tax cuts are needed in order to provide incentives for growth must confront the fact that innovation and growth have been spectacular for a number of years, with rising wages and family incomes. To demand a major shift in economic policy because of a few slow quarters makes no sense.

The size of Federal discretionary spending relative to the size of the economy was substantially reduced in the 1990s and it will be hard to go much further. (Discretionary outlays fell from 8.6 percent of GDP in FY 1992 to 6.3 percent in FY 2000). There is broad agreement that America needs a strong defense in a dangerous world. It would be a mistake to cut support for research, education, child-care assistance, and other needed

programs in order to finance a large tax cut. Budget projections must be based on a realistic view of what spending is likely to be.

A strong economy demands investment in the future. Fiscal discipline encourages private sector investment. The Federal government makes health, technology and education investments that support American families and support the private sector.

The Challenge for Social Security and Medicare

Projections indicate that the population aged 65 and over will rise from its current share of about 12 1/2 percent of the total population to nearly 21 percent by 2040. Currently the Social Security and Medicare trust funds are running surpluses. But as the proportion of elderly in the population rises, this situation will reverse and the trust funds will run deficits and become depleted, in the absence of any reforms. Medicare also faces the pressures coming from projected increases in health care costs. The long run fiscal position of the Federal government is not nearly as rosy as the short run position.

For Social Security in particular, the trust fund is expected to run out by 2038. Current budget surpluses provide the opportunity to carry out long run reform. The problem of Social Security funding could be solved once-and-for-all by shifting from the current pay-as-you-go system to a fully-funded system. Today, the benefits paid to retirees come from the Social Security taxes paid by current workers. In a fully-funded system, the moneys paid in by current workers would be used to purchase bonds or stocks. On retirement, participants would receive an annuity income paid for by the wealth they had built up in the system. It is very hard to get from where we are now to this new situation because of the transition problem. The current Social Security surplus will be needed to pay today's workers as they retire. But part or all of the budget surpluses over and above the Social Security surplus could be used to ease the transition problem and allow us to start the shift towards a fully-funded system.

Dealing with the Current Account Deficit

The US is now borrowing \$500 billion a year to finance its trade and current account deficit with the rest of the world. This is about 5 percent of GDP and we have already accumulated \$2 trillion of net indebtedness to the world. Americans benefit from the ability to buy more goods overseas than it sells and attract foreign capital to pay for it. But all of that borrowing will have to be serviced over time. The huge trade and current account deficits are not sustainable in the long run. We cannot continue to borrow at this rate indefinitely.

Running an international or current account deficit means that, as a nation, we are spending more than we are producing. American families spend most of the income they receive, setting aside very few cents of each dollar in the form of saving. Total saving out of National Income does not finance the level of investment businesses see as profitable, and so the gap is filled by foreign borrowing.

The strong US economy has helped to offset this low saving out of income. Americans are much wealthier than they were in 1990 because of the rise in the stock market and in housing values. But it is time for us to accumulate wealth the old-fashioned way, by saving more. There are limits to the flow of capital that can be provided by other countries. US interest rates will rise as those limits are reached and abrupt changes in the dollar are possible, just as happened in the 1980s.

Historically, the Federal government has run budget deficits that were a reduction in national saving. But in the past few years the budget surpluses have contributed positively to national saving. It is vital to continue that contribution and not undermine the needed increase in national saving.

Doing More: Decreasing Uncertainty

One reason that some Americans are nervous is that losing a job can be such a traumatic event. The long period of good times has led many to stretch themselves with credit card debt or big mortgage payments. Being out of work could break the bank very quickly. And tax cuts do not do much to help those who do not have jobs. Losing a job often means losing health insurance coverage.

The current slowdown is a good time to look at programs that reduce the economic uncertainty faced by American families. Is the current unemployment compensation system adequate? Is there adequate help in dealing with credit cards or other debt problems? Will families be punished by creditors following a spell of unemployment? How do we make sure that job losers can still take their children to the doctor? Do we provide enough assistance to help people who must find new jobs? Why don't we do something to help the 40 million Americans without health insurance? That would sure help consumer confidence.

Conclusion

The amazingly strong economic performance of the US economy in recent years, with strong accelerating growth through mid 2000, should provide a guide to future policy choices. Having found policies that have worked so well, let's stick with them. The current slowdown is cyclical not structural and we need to stay on the long-run course.

Monetary policy is the strongest and most effective medicine to fight off a recession or restore growth if a recession should happen. Let's give this medicine a chance to work.

It is not clear that any fiscal stimulus package is needed or would be very effective. But if one is passed, it should be immediate, modest in size and geared to help low and moderate income families.

Preserving fiscal discipline increases national saving, encourages investment and productivity growth and reduces our international deficit. And these, in turn, increase wages and family incomes.

Policies to preserve fiscal discipline must be based on a realistic assessment of spending and must allow for the great uncertainty of revenue estimates.