Statement of Alice M. Rivlin*
The Brookings Institution

before the

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Congress of the United States

"The Budget and Economic Outlook"

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Mr. Chairman and members of the Committee:

I am pleased to have the opportunity to offer my views this morning as you address the challenges presented by large projected federal budget surpluses. I have appeared before this committee many times, often to discuss the challenges presented by large projected deficits. The change is a welcome one!

The budget and economic news of recent weeks is extremely confusing. In a single newscast, one easily might hear three seemingly contradictory stories. The first story says that the economy is turning sour—people are being laid off and we might even be headed for a recession. The next story tells us that the federal budget outlook is getting better—projections of federal surpluses over the next decade are now even larger than they were last year when the economy was stronger. The final story points out that in the longer run the economy is headed for trouble—the population is aging, social security and medicare are under-funded, and, when the baby boomers retire, the government will have to raise taxes, borrow a lot more, or cut their benefits. It is pretty hard for most people to figure out how these stories fit together, but, in fact, they are all true.

In the last few months economic growth has slowed dramatically from its rapid pace of the last half of the 1990s. Manufacturing employment has been dropping since July, although job

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- Senior Fellow and Adeline M. and Alfred I. Johnson Chair in Urban and Metropolitan Policy.

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growth continues at a moderate pace in other sectors. Sales have fallen off, inventories have risen, profits are falling, consumer confidence has plummeted, and investors have grown more wary of taking risks. Right now, no one knows if the economy is headed for serious recession, but I doubt it. I share the view of most forecasters that we are likely to experience two or three very slow quarters followed by a pick up in growth before the end of the year.

This relatively optimistic expectation—a short, shallow dip, but no serious economic setback—is based on the perception that technology continues to generate new products, processes, and investment opportunities, and the highly competitive U.S. economy is well positioned to respond positively. The Federal Reserve has already moved aggressively to lower interest rates, and still has plenty of room to ease further over coming weeks. Prospects for avoiding recession seem good, provided that consumer and investor confidence recover.

It makes a lot of difference whether the optimists prove right. A short, shallow dip in the economy would be hard on people who lose jobs and obliterate the profits of many businesses, but it would not create widespread disruption or affect the longer run budget outlook substantially. A deeper, longer recession, would darken the lives and dash the hopes of a great many people and businesses. It would be particularly unfortunate for newly employed former welfare recipients without strong work skills or seniority. It would also reduce the projected budget surpluses significantly, probably restoring on-budget deficits and delaying the repayment of debt.

The projections of rapidly growing federal budget surpluses for the next decade, recently issued by OMB and CBO, assume slower growth in the current year, but no serious recession. Nevertheless, the aggregate ten-year forecasts are significantly bigger (a trillion dollars is significant!) than last year's forecast. One reason why the projected surpluses are larger is just mechanical. Dropping FY 2001, which has a small surplus, and adding 2011, which has a large one, would increase the decade total even if the annual estimates did not change. The second reason is more interesting. Most economists, including those at OMB and CBO, have gradually come to the conclusion that the economy can grow faster without igniting inflation than they used to think it could. The acceleration in productivity growth in the period 1996-2000, and the fact that low unemployment for several years did not generate worrisome inflation, has lead most economists to believe that the economy can grow at around 3 percent a year without risking an acceleration of inflation. CBO and OMB both assume that trend growth is roughly 3 per cent, although CBO's budget-estimating methodology produces larger surplus projections than OMB's.

These economic assumptions are not wildly optimistic. Economic experience since the mid-1990s has provided substantial reasons to hope that productivity growth in the U.S. has finally pulled out of its slump and onto a faster trend. The three per cent growth path assumed by OMB/CBO is a highly defensible guess. The economy might even grow faster. But the trend growth rate is just that, a guess, and the surpluses it implies are by no means guaranteed. We will have a better idea whether the productivity growth acceleration experienced in the late 1990s is going to prove durable when we see what happens to productivity growth as the economy slows down.

The dilemma posed by forecasts is that they are both necessary and highly uncertain. The Congress has to make decisions based on the best guesses available about the future, but it is only prudent to keep in mind that the guesses might be wrong and to avoid taking actions that will be hard to reverse if circumstances change and unforeseen contingencies arise. It is especially important to avoid actions that respond to immediate problems, but create bigger difficulties down the road.

An apparent paradox of the current situation is that, while the growth rate of the economy over the coming decade is quite uncertain, the demographic pressure on that economy in the *following* decade (after 2010) is far more certain. We can count on the fact that the proportion of older people in the population will rise dramatically between 2010 and 2020 and will continue high. We know the cost of retirement benefits and medical care for the older population will soar. The practice of focussing on ten-year economic and budget forecasts hides a huge problem looming just beyond the ten-year horizon.

If the federal budget surpluses projected over the next decade do materialize, they will provide an enormous opportunity for Americans to live more fulfilling lives, not just in the coming decade, but over decades to come. This opportunity will test our Nation's ability to use our democratic processes to consider the options and direct these substantial resources—whether to debt reduction, tax cut or spending increases—to uses that have the best chances of giving citizens what they most want for the present and the future.

In the face of projected long-run surpluses, both tax reductions and spending increases deserve serious consideration. The principal argument for devoting the surpluses to tax cuts is that individuals are better judges of their needs than the government and more likely to spend the money effectively. This was the main argument that President Bush used to defend his tax cut proposals during the presidential campaign. The argument for government spending is that the Nation's most urgent needs will not be met by increased private spending alone—especially more effective education and skills mastery that enables workers to hold productive jobs, health care coverage for working families that cannot afford it, and the transformation of the social security and medicare programs to meet the needs of the rapidly growing retired population. The relative emphasis to be placed on public and private needs involves value judgments on which people differ. I am among those who believe that meeting these urgent public needs should be given extremely high priority in allocating the projected surpluses. To me, it seems short-sighted and counterproductive to commit most of the projected surplus to tax cuts now and then find ourselves without the resources to invest in the quality of education, health care coverage and retirement security that Americans need and deserve.

It is especially important that tax cuts not be enacted for inappropriate reasons. Monetary policy is a much more flexible instrument for fighting recession than tax policy. It can be employed quickly—as the Federal Reserve has already proved—and can be reversed easily. Tax cuts take time to work their way through Congress and are likely to come into effect about the time the recession is over. Since a tax reduction that over-stimulates the economy is almost impossible to reverse, the likely result will be that the Federal Reserve will have to raise interest rates. If we want to promote economic growth, we would be better off with lower interest rates and tighter fiscal policy than with the opposite combination.

Another rationale for near-term tax cuts was offered in recent testimony before this Committee by Federal Reserve Chairman Alan Greenspan. The Chairman is concerned that the projected surpluses will reduce the debt held by the public to such a low level that the government will find itself having to invest in nonfederal securities. He is afraid that these investments might be subject to political pressure and would result in the allocation of capital to companies other than the most profitable ones. The chairman is raising a serious issue, but one I believe could be solved. The social security and medicare accounts could invest in index funds well-insulated from political influence, in the manor of the federal Thrift Savings Plan. It seems to me far easier to safeguard such investments than to cope with the under-funding of social security and medicare after large tax cuts eliminate the projected surpluses that could be used to ensure their future solvency.

In short, I believe that the currently projected ten-year surpluses are good guesses—the best available guesses—but that they are by no means guaranteed. Moreover, the ten-year horizon is too short. We need to respond now to the looming demographic pressures of the years beyond 2011. I believe committing to a massive tax cut now, especially one undertaken to counter a temporary downturn in the economy, would be short-sighted. We have time to see whether the surpluses turn out to be as large as currently projected and to debate whether public needs should have priority over private spending.

Thank you, Mr. Chairman and members of the Committee.