Testimony on Proposals for Economic Growth and Job Creation

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Mr. Chairman, Senator Baucus, and Members of the Committee, it is an honor to appear before you to discuss proposals for economic growth and job creation. In evaluating such proposals, it is important to distinguish between the short run and the long run.

- In the short run, a key economic difficulty is that the nation is not fully using the capacity it has available to produce goods and services. As one indication of unused capacity, the capacity utilization rate for December 2002 computed by the Federal Reserve Board of Governors was 75.4 percent, significantly below its average of 81.5 percent for the past three decades.[2] Given unused capacity, the crucial step to higher economic growth in the short run is expanded aggregate demand for the goods and services that firms could produce today. In other words, higher spending would encourage firms to more fully use available resources.

- In the long run, the key to economic growth is to expand the capacity of the nation to produce goods and services. The challenge is therefore much different: rather than ensuring that we are using all the capacity we have, which is a short-run issue, the long-run challenge is to boost the growth rate of that capacity over time. A primary determinant of how quickly that capacity increases is our nation's saving rate. Higher national saving is reflected in either increased domestic investment or reduced borrowing from abroad, or both. Which of these two effects predominates, in the end, is not very important; either way, Americans end up owning a larger capital stock in the future. The returns to that higher capital stock increase national income in the future. The single most important step that policy-makers could take to raise national saving is to restore long-term fiscal discipline to the Federal budget.

The different needs for the short run and the long run complicate the challenges facing policy-makers, since the appropriate policies for the short run may be exactly the opposite of the appropriate policies for the long run. For example, spurring consumption would arguably be beneficial in the short run, since it would expand the demand for goods and services. But spurring national saving would be beneficial in the long run, since it would finance expansions

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[2] See http://www.federalreserve.gov/releases/G17/Current/default.htm.

in capacity and the capital stock owned by Americans. The expanded capital stock in turn would raise future national income.

My testimony argues that:

- The Administration's tax proposals are not well-designed for boosting growth in either the short run or the long run, since they would have only modest effects on demand in 2003 and would expand budget deficits in the long run. All else being equal, the expanded budget deficits would reduce national saving in the long run, exactly the opposite of what would be needed to boost growth.

- A more auspicious set of policies, given current conditions and the different imperatives for the short run and the long run, would combine a targeted short-term stimulus package with long-term fiscal discipline. In particular, a well-designed and timely short-term stimulus package could significantly bolster aggregate demand in 2003. Such a package should be limited to 2003 only, should amount to about one percent of GDP, and should include:

  - Temporary fiscal relief to the states to mitigate the reductions in expenditures and increases in taxes that states are undertaking;
  - Temporary increased Federal government purchases of goods and services, especially in homeland security;
  - Temporary incentives for businesses to accelerate investments into 2003; and
  - Temporary, progressive tax cuts aimed at those households most likely to spend the funds.

  This short-term package should be coupled with policies to narrow the long-term budget gap, which would provide some additional short-term benefit by putting further downward pressure on long-term interest rates. More importantly, the combination of short-term stimulus and long-term fiscal discipline would best address the economic challenges facing the nation: It would boost demand in the short run and national saving in the long run.

Before examining these points in more detail, it is worth noting that both monetary policy and fiscal policy have already provided a significant amount of short-term stimulus, and many economists do not believe that any further fiscal stimulus is warranted – especially since the history of efforts to stimulate the economy using fiscal policy is not particularly encouraging.

In my opinion, the case for further short-term fiscal stimulus is a close call but remains persuasive. The downside risks to economic performance loom larger than the downside risks of a well-designed stimulus package, in part because the extraordinarily low level of inflation presents asymmetrical risks (given current conditions, further potential reductions in price inflation from its already low level entail larger perils, including the admittedly remote possibility of deflation, than potential increases of the same magnitude). Nonetheless, the debate about whether further fiscal stimulus is even warranted underscores three points. First,

any short-term stimulus package should be enacted as soon as possible, to maximize the likelihood that it takes effect while the economy is still weak and thus that it is in place in time to accelerate the recovery. Second, the stimulus package should be limited in size to about one percent of GDP and well-targeted to boosting demand in the short run. Third, the stimulus package should not significantly exacerbate the long-term budget outlook. As I indicated previously, one reason that it is important not to exacerbate the long-term budget outlook is that budget deficits reduce national saving, which in turn reduces economic growth (all else being equal).

Administration's tax proposals

The Administration has proposed two sets of tax cuts: those included in its growth package and other tax cuts included in the budget. The growth package would, along with other smaller changes, make the 2001 tax cut permanent and exclude dividends and some capital gains from taxation at the individual level. The additional tax cuts in the budget include, most prominently, expanded tax-free savings accounts with no income limits. These proposals do not seem well-designed for either the short run or the long run, since they would fail to do much to boost demand in 2003 and would expand budget deficits in the long run.[3]

A letter released yesterday that was signed by 10 Nobel Prize winners in economics, along with more than 400 other economists (including myself), emphasized:[4]

> "Economic growth, though positive, has not been sufficient to generate jobs and prevent unemployment from rising. In fact, there are now more than two million fewer private sector jobs than at the start of the current recession. Overcapacity, corporate scandals, and uncertainty have and will continue to weigh down the economy.
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> The tax cut plan proposed by President Bush is not the answer to these problems. Regardless of how one views the specifics of the Bush plan, there is wide agreement that its purpose is a permanent change in the tax structure and not the creation of jobs and growth in the near-term. The permanent dividend tax cut, in particular, is not credible as a short-term stimulus. As tax reform, the dividend tax cut is misdirected in that it targets individuals rather than corporations, is overly complex, and could be, but is not, part of a revenue-neutral tax reform effort.
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> Passing these tax cuts will worsen the long-term budget outlook, adding to the nation's projected chronic deficits. This fiscal deterioration will reduce the capacity of the government to finance Social Security and Medicare benefits as well as investments in schools, health, infrastructure, and basic research. Moreover, the proposed tax cuts will generate further inequalities in after-tax income.

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[3] For a quantitative analysis of the Administration's growth package, see Macroeconomic Advisers, LLC, "A Preliminary Analysis of the President's Jobs and Growth Proposals," January 10, 2003. The report does find a significant increase in demand in the short run, but also finds that the proposals would reduce potential GDP in the long term: "Initially the plan would stimulate aggregate demand significantly by raising disposable income, boosting equity values, and reducing the cost of capital. However, the tax cut also reduces national saving directly while offering little new, permanent incentive for either private saving or labor supply. Therefore, unless it is paid for with a reduction in federal outlays, the plan will raise equilibrium real interest rates, crowd out private-sector investment, and eventually undermine potential GDP."

[4] See http://www.epinet.org/stmt/2003/statement_signed.pdf.

> To be effective, a stimulus plan should rely on immediate but temporary spending and tax measures to expand demand, and it should also rely on immediate but temporary incentives for investment. Such a stimulus plan would spur growth and jobs in the short term without exacerbating the long-term budget outlook."

That letter was written primarily in response to the Administration's growth package, which was announced on January 7th.[5] More recently, the Administration's budget included a proposal to create new tax-advantaged savings accounts, in the form of Retirement Savings Accounts (RSAs) and Lifetime Savings Accounts (LSAs). Such accounts would significantly reduce revenue when the baby boomers are retired, both because they would shelter substantial (and growing) amounts of assets from taxation and because the encouragement of rollovers from existing tax-deferred saving into the back-loaded RSA saving plans would generate a shift of revenues from outside the 5-year budget window to inside that window. The result would be the loss of tens of billions of dollars per year when the budget is already projected to be under pressure from the retirement of the baby boomers.

Furthermore, the proposed accounts are unlikely to produce a significant increase in private saving: The contributions to the tax-preferred accounts will disproportionately reflect shifts of assets from taxable accounts into tax-sheltered accounts by high-income households, rather than new saving.[6] The vast majority of households – roughly 95 percent – do not maximize their *existing* tax-preferred savings, so expanding the opportunities for such saving is unlikely to generate a significant increase in saving for them.[7] Higher-income households already saving substantial amounts outside of tax-advantaged accounts, however, will likely shift their assets into the tax-sheltered account. The result is little, if any, net increase in private saving. The combined effect of the reduction in government revenue and the modest increase in private saving is unlikely to be a significant increase in national saving, and may well be a decline.

Economic effects of deficit-financed tax cuts

An important aspect of all the Administration's tax proposals -- including making the 2001 tax cuts permanent, the new dividend proposal, and the new savings proposal -- is that they are all deficit financed. The implied revenue losses are substantial: The tax cuts would amount to approximately 1.7 percent of GDP in FY 2013, for example.[8] That 1.7 percent of

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[5] For further analysis of the dividend proposal, see William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," The Brookings Institution, January 13, 2003; and William G. Gale and Peter R. Orszag, "The President's Tax Proposals: Second Thoughts," *Tax Notes*, January 27, 2003.

[6] Even academics who believe that 401(k) plans and IRAs raise private saving have questioned whether private saving will increase significantly if the new proposals were enacted. See Daniel Altman, "Accounts Chock-Full or a Plan Half Empty," *The New York Times*, February 1, 2003.

[7] Carroll (2000) reports that only 4 percent of eligible taxpayers made the maximum $2,000 contribution to a traditional IRA in 1995. Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000. Estimates in Copeland (2002) suggest that about 3 percent of individuals made the maximum contribution to a traditional IRA in recent waves of the Survey of Income and Program Participation (covering 1997, 1998, and 1999). Craig Copeland, "IRA Assets and Characteristics of IRA Owners," EBRI Notes, December 2002. The 2001 tax legislation, furthermore, included scheduled increases in IRA limits, which are $3,000 this year and are scheduled to rise to $5,000 by 2008. The likely result is that even fewer taxpayers will be constrained in the amount of their IRA contributions than the historical data suggest.

[8] According to the Treasury "Blue Book," the revenue loss in FY 2013 is $299 billion. The Administration did not provide GDP projections for FY 2013, but the CBO estimate of GDP for FY 2013 is $17.851 trillion. The Treasury revenue loss is 1.7 percent of the CBO GDP projection in FY 2013. In addition, the Administration's estimate of nominal GDP in calendar year

GDP figure may understate the permanent cost of the Administration's tax proposals, since it is artificially restrained by failing to address the looming alternative minimum tax problem and since it does not fully reflect the long-term cost of the proposed savings accounts. To put the 1.7 percent of GDP figure in context, the projected 75-year deficit in Social Security is 0.7 percent of GDP.[9] The proposed tax cuts are thus more than twice the size of the Social Security deficit over the next 75 years.

It is important to emphasize that deficit-financed tax cuts are unlikely to have significant positive effects on economic growth in the long term, and may well reduce it. A full analysis of tax cuts that result in larger budget deficits needs to take into account (1) the direct effects of the policy in question, ignoring any change in the deficit; and (2) the decline in national saving caused by the expanded budget deficit.

The most recent prominent example of the tradeoffs involved is the 2001 tax cut. The net effect of the 2001 tax cut on growth is the sum of its (possibly positive) effect from changes in incentives and its (negative) effect through increases in the budget deficit. Given the structure of the 2001 tax cut, researchers have generally found that the negative effects of the tax cuts via expanded budget deficits (and reduced national) saving offset and potentially outweigh any positive effects on future output from the impact of reduced marginal tax rates.[10] Similarly, an analysis of the new tax cuts proposed by the Administration needs to account for any positive incentive effects from reduced taxes *and* negative effects from expansions of the deficit and reduced national saving.

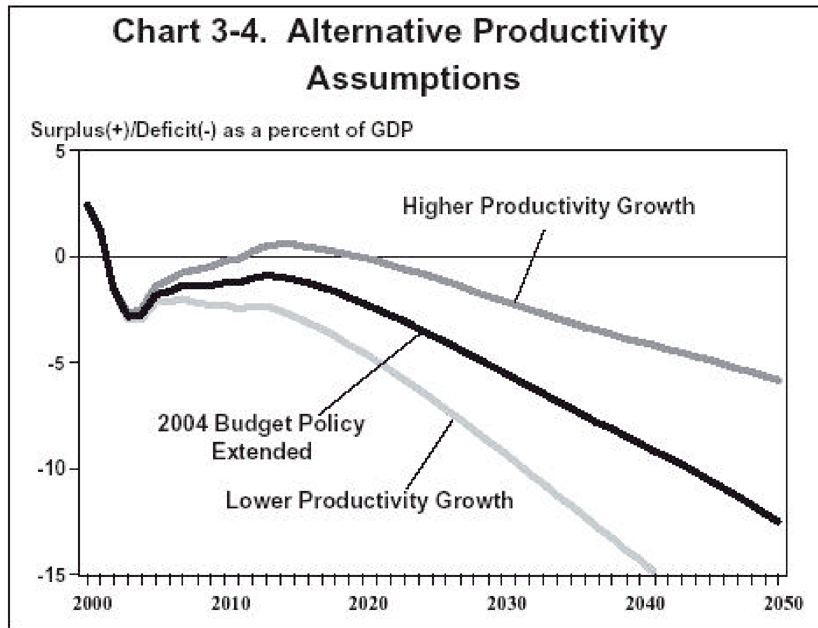
Long-term budget outlook under the Administration's budget

Two other points are worth noting briefly about the Administration's budget. First, Table 2-5 of the *Analytical Perspectives* (a part of the Administration's published budget) shows a structural budget deficit in 2008 of $189.6 billion, or slightly more than one percent of GDP. That deficit cannot be attributed to the business cycle, since a structural deficit by definition is one that has already adjusted for the state of the business cycle. Nor can it be blamed on any other irregular factors, since there is no reason to believe that 2008 will be an atypical year. It instead reflects an underlying imbalance between revenue and expenditure (which is actually wider than shown in the budget, because of unrealistic assumptions regarding the alternative minimum tax and other factors).

2008 is $13.919 trillion, relative to CBO's projection of $14.154 trillion. If the ratio of the Administration's projection to CBO's projection in calendar year 2008 applied in FY 2013, the implied Administration forecast would be $17.555 trillion. The Treasury projection of the revenue loss is 1.7 percent of this constructed GDP forecast.

[9] Social Security Administration, 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Table VI.E5, page 164.

[10] See Alan J. Auerbach, "The Bush Tax Cut and National Saving," Prepared for the 2002 Spring Symposium of the National Tax Association, May 2002; Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2001; Douglas W. Elmendorf, and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," Prepared for the National Tax Association's 2002 Spring Symposium; and William G. Gale, and Samara R. Potter. 2002, "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," *National Tax Journal* Vol. LV, No. 1 (March): 133-186. One reason for the tepid estimated response to the 2001 tax cut is that 64 percent of filers, accounting for 38 percent of taxable income, would receive no reduction in marginal tax rates, according to Treasury estimates (Kiefer et al 2002).



Source: FY 2004 Budget, *Analytical Perspectives*, Chart 3-4

Second, the budget shows substantial out-year deficits, as depicted in Chart 3-4 (also taken from the *Analytical Perspectives*), even if productivity growth turns out to be higher than currently expected. In the face of these substantial deficits, enacting large, permanent tax cuts must mean some combination of: (1) shifting tax burdens to future generations, which will already be facing higher taxes based on current projections; (2) reneging on government promises in some form; or (3) running substantial budget deficits that would likely become unsustainable.

Proposals to boost growth in the short term and long term

If the Administration's proposals do not seem appropriate in either the short run or the long run, what should be done instead? The most promising set of policies, given current conditions and the different imperatives for the short run and the long run, would combine a targeted short-term stimulus package with long-term fiscal discipline. In particular, a well-designed and timely short-term stimulus package could bolster aggregate demand in 2003. Such a short-term package should include temporary fiscal relief to the states to mitigate the reductions in expenditures and increases in taxes that states are undertaking; temporary increases in Federal government purchases of goods and services, especially in homeland security; temporary incentives for businesses to accelerate investments into 2003; and temporary progressive tax cuts aimed at those households most likely to spend the funds.

Fiscal relief to the states

The projected deficit in state budgets for Fiscal Year 2004, which begins in most states on July 1, totals at least $65 billion, with some estimates ranging as high as $85 billion.[11] All

[11] See National Conference on State Legislatures, "State Budget Gaps Growing at Alarming Rate," February 4, 2003, and Iris J. Lav and Nicholas Johnson, "State Budget Deficits for Fiscal Year 2004 are Huge and Growing," Center on Budget and Policy Priorities, January 23, 2003.

states except Vermont have some form of balanced budget requirement.[12] In response to the projected and current budget deficits, states are therefore raising taxes and cutting spending -- steps that are counterproductive from a macroeconomic perspective. Fiscal relief from the Federal government would mitigate the need for the states to undertake these problematic tax increases and spending reductions.[13] In designing the fiscal relief package, Federal policy-makers should take into account both the immediate benefit of assisting the states and the potential moral hazard created (i.e., that assisting the states now may discourage them from acting responsibly during the next business cycle).

Increased Federal government purchases of goods and services, especially in homeland security

Expansions in government spending are often more stimulative in the short run than tax cuts, because part of the tax cut is likely to be saved rather than spent.[14] Elmendorf and Reifschneider (2002) use a large-scale econometric model developed at the Federal Reserve and find that an expansion in government spending generates a larger increase in GDP in the short run than does an equal-dollar-magnitude reduction in personal income taxes.[15] As they note, "Changes in government spending have a larger stimulative effect than changes in taxes because a sizable share of each dollar of lower taxes goes to private saving, whereas each dollar of additional government spending boosts aggregate spending by the full dollar."[16]

A particularly promising area for temporary increases in government spending is homeland security. The Administration has proposed $41 billion in homeland security spending for FY 2004. A Brookings team, of which I was part, concluded that roughly $5 billion in additional spending on homeland security would be warranted.[17] In addition to improving homeland security, such funds would expand short-term demand for the goods and services produced by private firms.

Investment incentives

Since the Committee will be holding a separate hearing on investment incentives, I will merely note two recent documents in which co-authors and I have discussed incentives to

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[12] The form of the balanced budget rule varies from state to state, with the requirements being easier to meet in some states than others.

[13] See Alice Rivlin, "Another State Fiscal Crisis: Is There a Better Way?" Brookings Institution Policy Brief #23, January 2003.

[14] See, for example, Peter Orszag and Joseph Stiglitz, "Tax Cuts Are Not Automatically the Best Stimulus: A Response to Glenn Hubbard," Center on Budget and Policy Priorities, November 27, 2001 and CBSMarketwatch, November 30, 2001.

[15] Douglas W. Elmendorf and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," *National Tax Journal*, Volume LV, No. 3, September 2002.

[16] Elmendorf and Reifschneider, page 382.

[17] Ivo Daalder, Mac Destler, David Gunter, James Lindsay, Michael O'Hanlon, Peter Orszag, and James Steinberg, "Protecting the American Homeland: One Year On," The Brookings Institution, January 2003; and Michael O'Hanlon, Peter Orszag, Ivo Daalder, Mac Destler, David Gunter, Robert Litan, and James Steinberg, *Protecting the American Homeland: A Preliminary Analysis* (Brookings Institution Press: 2002).

boost investment in the short term.[18] My colleague William Gale will discuss investment incentives in his testimony on the appropriate panel.

Progressive, temporary tax cuts

Finally, a stimulus package could include progressive, temporary tax cuts. It is worth noting that research suggests that in the past, households have spent in the short term between 20 percent and 70 percent of any temporary income tax cuts they receive.[19] One recent paper suggests that the 2001 tax rebates generated particularly modest increases in spending.[20] One reason for somewhat modest effects from many temporary tax cuts is that most households base their spending decisions on longer-term income averages, rather than just this year's after-tax income.[21] However, a significant share of income – somewhere between 15 percent and 50 percent – accrues to households that seem to behave as if they base their consumption decisions on current income alone.[22] Focusing temporary tax cuts on such households, who are disproportionately lower-income households living paycheck to paycheck, would magnify the effect on current consumer spending.[23] The rebate from the 2001 tax cut either excluded, or

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[18] William Gale, Peter Orszag, and Gene Sperling, "Tax Stimulus Options in the Aftermath of the Terrorist Attack," *Tax Notes,* October 8, 2001, and Peter Orszag, "Evaluating Economic Stimulus Proposals," Testimony before the Senate Budget Committee, October 25, 2001.

[19] For example, see Alan S. Blinder, "Temporary Income Taxes and Consumer Spending," *Journal of Political Economy*, February 1981, pages 26-53; James M. Poterba, "Are Consumers Forward Looking? Evidence from Fiscal Experiments," *American Economic Review*, May 1988, pages 413-8; Matthew D. Shapiro and Joel Slemrod, "Consumer Response to the Timing of Income: Evidence from a Change in Tax Withholding," *American Economic Review*, March 1995, pages 274-83; Nicholas Souleles, "The Response of Household Consumption to Income Tax Refunds," *American Economic Review*, September 1999, pages 947-58; and Chris Carroll, "A Theory of the Consumption Function, With and Without Liquidity Constraints (Expanded Version)," NBER Working Paper 8387, National Bureau of Economic Research, July 2001.

[20] Matthew D. Shapiro and Joel Slemrod, "Did the 2001 Tax Rebate Stimulate Spending? Evidence from Taxpayer Surveys," NBER Working Paper 9308, November 2002.

[21] Some observers have concluded that permanent tax cuts are therefore likely to be more effective at stimulating the economy than temporary ones. Three observations are worth noting about this argument. First, the theory behind this statement suggests that spending will be proportionate to the permanent size of the tax cut; the larger increase in consumption that results from a permanent tax cut therefore merely reflects the larger permanent revenue loss involved. Second, the argument ignores the effect of permanent revenue losses on long-term interest rates and therefore on current economic activity. Third, the argument ignores the significant minority of households who base their spending decisions on current income rather than some measure of long-term average income.

[22] See Robert J. Gordon, *Macroeconomics* (Addison Wesley: 2000), pages 506-506. Campbell and Mankiw (1990) estimate that 40 to 50 percent of income accrues to individuals who consume based on current income rather than permanent income. See John Y. Campbell and N. Gregory Mankiw, "Permanent Income, Current Income, and Consumption," *Journal of Business and Economic Statistics*, Vol. 8, No. 3, July 1990. Other articles suggest a somewhat lower share.

[23] Dynan, Skinner and Zeldes (2000) show that, in several different data sets, propensities to consume out of current and permanent income fall as those income measures rise. Parker (1999) uses data from the Consumer Expenditure Survey and finds that the marginal propensity to consume (MPC) out of transitory income at low levels of resources (which for most low-income households is effectively current income) is much higher than the MPC out of transitory income for very high-income households. McCarthy (1995) uses data from the Panel Survey of Income Dynamics and shows that the marginal propensity to consume out of idiosyncratic income shocks is larger for low-wealth households than for high-wealth households. See Karen E. Dynan, Jonathan Skinner, and Stephen P. Zeldes, "Do the Rich Save More?" NBER Working paper 7906, National Bureau of Economic Research, September 2000; Jonathan Parker, "The Consumption Function Re-estimated," August 1999; and Jonathan McCarthy, "Imperfect Insurance and Differing Propensities to Consume Across Households," *Journal of Monetary Economics,* November 1995, pages 301-27.

provided only a partial rebate to, 51 million people.[24] Those excluded from the 2001 rebate were disproportionately workers who would be particularly likely to spend immediately any temporary tax cut.

Long-term fiscal discipline

Such a short-term package should be coupled with policies to narrow the long-term budget gap, which would provide some additional short-term economic benefit by putting further downward pressure on long-term interest rates.[25] More importantly, the combination of short-term stimulus and long-term fiscal discipline would best address the economic challenges facing the nation: It would boost demand in the short run and national saving in the long run.

Conclusion

The economic challenges facing the nation differ significantly depending on the time horizon. In the short run, a key challenge is to boost spending (to expand demand for the capacity we have available to produce goods and services). In the long run, a key challenge is to boost saving (to finance expansions in capacity over time). Unfortunately, the Administration's proposals seem poorly designed to meet either challenge. A better package would combine targeted short-term stimulus (limited to 2003 alone) with long-term fiscal discipline (to boost national saving).

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[24] Citizens for Tax Justice, "51 Million Taxpayers Won't Get Full Rebates from 2001 Tax Bill," June 1, 2001, available at http://www.ctj.org/html/rebate01.htm.

[25] For a review of the literature on deficits and interest rates, see William G. Gale and Peter R. Orszag, "The Economic Effects of Long-Term Fiscal Discipline," Urban-Brookings Tax Policy Center, December 2002.