# Fiscal Choices and Economic Challenges

## Testimony of
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Chairman Nickles, Senator Conrad, members of the Committee, thank you for the privilege of testifying on the state of the economy and economic policy today.

**I. State of the Economy**

No one of any economic or political perspective is satisfied with the nation's economic performance over the last two years. After the longest economic expansion in our nation's history, some were tempted to believe that the business cycle had been repealed: that downturns were a thing of the past. Unfortunately, we have learned that the business cycle cannot be repealed, because human nature – and its tendency to swing to extreme optimism and pessimism – cannot be repealed.

As we all are quite familiar with now, the strong and record expansion of the 1990s was dampened and ultimately cut short due in large part to significant overcapacity in American industry, particularly in the technology and internet sectors. Such overcapacity was no doubt driven by too many managers and investors basing their business expansion decisions on excessively optimistic valuations and growth projections. As businesses sought to reduce this overcapacity – and return to cost structures that could restore sustainable profitability – business investment fell significantly, eventually hurting job growth and consumer demand.

Many, including myself, saw the economy in a race of sorts: would consumer demand stay strong enough for businesses who had successfully pared back their cost structures to perceive strong enough demand to begin expanding their investment and payrolls? If so, the hope was that the period of economic weakness would be relatively short-lived. For a while, in early 2002, it looked as if such a positive scenario was indeed unfolding. In March 2002, for example, the ISM index showed manufacturing over 55 (growth is at 50) and the new orders index (often a leading indicator) over 65.

Yet, just as the recession turned out to be relatively shallow, the so-called recovery has been even more shallow and disappointing. The ISM index – while having a good month in December – dipped below 50 from September to November. New non-defense capital goods (excluding aircraft), after showing some bright spots in early 2002, fell four out of the five months between August and December 2002. While investment has moved into positive territory in several industries outside of telecommunications and aerospace, fixed non-residential investment has continued to fall in every quarter of 2002, and in the third quarter of 2002 was 5.1% below where it had been the year before. Capacity utilization is at only 75.4% -- 61.7% for high tech sectors -- and the Business Council Survey of major company CEOs in October 2002 showed that 78% were planning on either maintaining or even cutting back investment levels.[2]

Clearly, the stalling in the business sector has begun to wear away at the labor market and consumer resilience. Unemployment has risen; private sector jobs are down 2.3 million over the last two years, and even 219,000 in just the last two months. Consumer confidence, rather than rebounding on the news of at least moderate GDP growth, has fallen this month to its lowest level since November 1993,

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[2] "Market Weakness Persuades US Companies to Alter Business Plans," *Financial Times* (October 3, 2002), p. 10.

lower than even the months after the September 11 attacks. According to the Bank of Tokyo-Mitsubishi index, chain store sales in November and December grew by only 0.5% from the same period a year before -- the worst holiday season growth in the index's 32-year history.

Mr. Chairman, in an economy that is fundamentally driven by the growth and innovation spurred by the private sector, we all know that public policy will never be responsible for all of the good or all of the bad. It is unlikely that public policy could have completely prevented all of the excessive acts of corporate malfeasance or herd investing that have hurt our economy in the last couple of years. The basic test for public policymakers is twofold: how do we deal with the short-term economic hands that are we are dealt, and whether our long-term policies lay positive foundations or negative obstacles to economic confidence, growth and the process of innovation and wealth creation in the private sector.

Today, I would like to focus my comments on whether policymakers are employing a fiscal policy that is optimal both for dealing with short-term economic weakness and for laying a foundation for long-term economic growth and meeting our long-term economic challenges. I believe the recipe for our economy is to implement well-targeted policies to stimulate consumer demand and accelerate business investment in the short-term, while maintaining the long-term fiscal discipline that, by increasing savings and the supply of capital and providing confidence, ensures a strong long-term investment climate. Unfortunately, I fear that recent public policy has under-performed on both counts. On the one hand we have done too little to provided needed stimulus to the economy now. On the other, we have done too much to undermine our long-term savings, threatening confidence and our long-term investment climate.

## II. Effective and Efficient Stimulus

Mr. Chairman, while it is possible that the economy will recover without additional fiscal stimulus, the evidence of economic weakness and uncertainty seem strong enough to me to justify a temporary increase in the deficit to stimulate the economy as an insurance policy against a negative economic cycle taking hold. Such fiscal stimulus, however, is advisable only under two conditions. First, it must be done in the most efficient manner possible – the so-called bang for the buck calculation. This means we ensure as much of the cost of such a stimulus as possible be geared toward increasing consumer and business demand in the short-term when we need an economic boost. Second, the stimulus must not do further damage to our long-term fiscal situation. This goal is important not only for preventing needless harm to our future debt and deficit projections, but because the perception of long-term fiscal deterioration can hurt long-term economic confidence in a way that can negate some of the effectiveness of the stimulus package.

To date, I believe policy has been less than optimal in providing efficient stimulus.

### *A. Maximizing Efficiency of Stimulus? The Record So Far.*

- **Poorly Targeted and Timed Consumer Demand Incentives**: If the goal of an economic stimulus is to pump more demand into the economy in a timely fashion, policy should aim to provide benefits to those most likely to put money quickly into the economy – those with a so-called high propensity to spend. Unfortunately, the Administration has failed to follow that basic principle in devising its stimulus policies. After failing to propose any direct stimulus in their initial 2001 tax cut package, the Administration did cede to calls for some form of rebate that would go into family's pockets in 2001. Their proposal was to advance a small portion of the tax cut so that families received $300 or $600 in the fall of 2001 instead of the spring of 2002. Yet, this advance was not refundable, so the 34 million low-income taxpayers with the highest propensity to spend the money did not receive a dime, and 17 million more received only a partial tax cut. As the Congressional Budget Office recently stated "As a general proposition, higher-income households save more of their income than do lower-income households… Consequently, tax cuts that are targeted toward lower-income households are likely to generate more stimulus

dollar for dollar of revenue loss – that is, be more cost-effective and have more bang for the buck – than those concentrated among higher-income households."[3]

The Administration also missed the opportunity in both 2001 and 2002 to deliver a tax rebate before Christmas, when stores could have offered tempting deals, and consumers would have been most likely to spend the rebate, as some like myself called for.[4] On both occasions, no stimulus was passed before the Congressional Christmas recess.

Likewise, the Administration has been sparing in granting unemployment compensation, resisting Democratic attempts to extend benefits to the more than 1 million workers who have exhausted their benefits under the original extension.[5] This resistance comes even though unemployed families are not only among the most likely to spend the money, but are likely to do so in communities hardest hit by employment loss and subsequent falls in spending and demand. While poorly targeted unemployment compensation in a growing economy can stall job searches, with unemployment rising and the help wanted index at a 40-year low, this seemed to be a small risk. More targeting by the Administration and Congress toward helping with those with a higher propensity to spend may not only have helped some of our hardest pressed working families, it may also have helped the overall efficiency and effectiveness of recent stimulus efforts.

- **Poorly Designed Business Incentives:** Similarly, efforts to spark business spending have suffered from an inefficient approach to business incentives. A business stimulus should be clearly focused on encouraging businesses to accelerate investment into the period where there is a perceived weakness in economic demand. The rationale is that if business investment is weak, it can propagate weakness in the labor market and consumer confidence, leading to a downward cycle. While incentives to accelerate investment may simply be pushing up business investment that was planned for later years, the hope is that bringing some investment forward will forestall a downward cycle and quicken recovery.

  The three-year 30% business depreciation bonus ignores this fundamental logic. Because the incentive lasts three years (and perhaps, since it expires on September 11, 2004 right before an election, creates the expectation that it will be extended further) CEOs who were holding back even planned business investment in 2002 were given virtually no incentive to accelerate their plans. Our depreciation bonus essentially said to them: if you're sitting on the fence on new business investment, we are indifferent whether you invest now or continue sitting on the fence until 2004! It is as if a clothing store put out a sale for this weekend only and then told buyers they were only kidding, that all products would also be on sale on various weekends for the next year. Why would anyone feel they had to buy now? In passing the three-year stimulus provision, the Administration and Congress ignored sound analysis from the Congressional Budget Office that stressed what academic evidence and common sense suggests: temporary business incentives will be far more effective than longer term or permanent ones. "[T]he stimulus provided by some tax cuts for business investment can be increased by making them temporary. Firms may view them as one-time opportunities for tax savings, which may induce them to move up some of their future investment plans to the present. They might not take that step if they knew that the tax advantage would remain in place…"[6]

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[3] Congressional Budget Office. *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, January 2002, p. 7.
[4] Sperling, Gene, "In Crisis, Stimulus and Discipline Go Together," *Bloomberg News*, September 21, 2001; Sperling, Gene, "Remarks at the Democratic Economic Forum," October 2002.
[5] Primus, Wendell, Jessica Goldberg, and Isaac Shapiro, "New Unemployment Insurance Extension Neglects One million Jobless Workers Who Have Run Out of Federal Unemployment Benefits," Center on Budget and Policy Priorities, January 14, 2003.
[6] Congressional Budget Office. *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, January 2002, p. ix.

Other business provisions included in the March 2002 stimulus bill, including those which extend rules allowing financial corporations to defer tax on some of the income from their subsidiaries abroad and temporarily increase the number of years back a business could carry a net operating loss to offset the earlier year's taxes, have been found by the CBO to be ineffective stimulus. Likewise, the House proposed but did not pass the elimination of the Corporate Alternative Minimum Tax, which was also deemed ineffective stimulus.[7]

- **Failure to Address the Consequences of State-Level Contraction:** Another failure of recent stimulus efforts is that they have ignored the basic economic reality that it makes little economic sense to use federal policy to stimulate $1 of demand only to support policies that will lead states to contract demand by a $1. For well over a year, Governors, state legislators, and many policy analysts including myself have called for significant assistance to states so that stimulative tax cuts and spending increases at the federal level are not partially or fully canceled out by tax increases or spending cuts at the state and local level. The National Governors Association (NGA) called for state relief as part of the initial stimulus plan as early as October 2001.[8] Considering the need for states to increase spending on homeland security, this policy imperative seemed especially straightforward. Yet, significant aid to states has been lacking.

  Again, our economy is paying the price for such sub-optimal stimulus policies. The Center on Budget and Policy Priorities projects that states are facing the worst budget crisis in 50 years -- an estimated deficit of $70-85 billion in FY 2004.[9] If the high end of this estimate pans out, states will be forced to cut on average $1 out of every $6 they spend. Across the nation the lack of federal assistance has already led to property tax increases, spending cuts – even letting people out of jail. Certainly these policy measures – along with the screaming headlines announcing them – are hurting demand and confidence.

  There is, of course, a “moral hazard” argument for not going overboard in making states whole. If states believe they can run through rainy day funds for popular policy measures with knowledge that the federal government will bail them out, this could promote irresponsible future policy. Yet, a one time injection of $30-$40 billion for homeland security, Medicaid and other vital needs would certainly help economically without coming near bailing states out of all of their difficult choices.

***B. The Administration Seems Ready to Repeat the Same Mistakes.***

In light of these policy shortcomings it is particularly disappointing that the Administration is proposing policies that seem to make these same mistakes all over again.

- **Inefficient and Ineffective Stimulus**: Of the $674 billion in their economic package in direct costs and over $900 billion including lost interest savings – only 15% would actually help the economy in 2003. Simply put, we are deciding to add more than 3/4 trillion dollars to our national debt for tax cuts whose effect will be felt in years when we are not explicitly seeking to provide a short-term economic stimulus. The worst offender is the repeal of dividend taxation at the individual level. While one could argue that altering the taxation of dividends could improve capital allocation efficiency as part of a comprehensive corporate reform that also closed loopholes leading to “zero” taxation and was deficit neutral, the provision is widely acknowledged as a very poor stimulus. Indeed, when one considers both the program's uncertain benefits and its long-term cost, this proposal cannot be economically justified at this time.

[7] Congressional Budget Office. *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, January 2002.
[8] "Governors Propose Package To Strengthen State-Federal Safety Net," National Governors Association News Release, October 4, 2001.
[9] Lav, Iris, and Nicolas Johnson, "State Budget Deficits for Fiscal Year 2004 are Huge and Growing," Center on Budget and Policy Priorities, January 23, 2003.

Other provisions also fail the efficiency test. While increasing the tax cuts for middle-income taxpayers and the child tax credit in 2003 can be justified on stimulus grounds, the complete acceleration of 2006 cuts increases deficits in the years 2004 and 2005, when we may wish to be more focused on increasing national savings than on further stimulus.

- **Inefficient Business Incentives:** Other than the dividend exclusion, the only business incentive in the Administration's proposal – the increase in Section 179 to $75,000 – is permanent, meaning that it is unlikely to provide an incentive for any short-term acceleration of business investment.

- **Poorly Targeted to Consumers with High Propensity to Spend:** While as mentioned above, some of the Administration's tax cuts should be considered if they were limited to 2003, the Administration again leaves out lower income taxpayers who would have the highest propensity to spend. While taxpayers earning over $1 million would average nearly $90,222 in tax cuts in 2003, close to half of tax filers would receive $100 or less.[10]

- **No Help To States**: Despite now overwhelming evidence that states are forced to counter federal stimulus efforts with contractionary tax increases and spending cuts, the Administration's proposal not only fails to give states any assistance, but the proposal would deepen their short-term hole by $4 billion.

***C. Recommended Policies***

1. **No Long-term Deficit Costs Outside of 2003:** The fundamental rule for the efficiency of stimulus and the test for ensuring long-term fiscal strength is that all increases in the deficit are limited to efforts to directly stimulate the economy in 2003. Therefore, all consumer tax cuts and business incentives should be limited to the current calendar, if not fiscal, year.

2. **Temporary Increase Business Incentive**: Since October 2001, I have proposed a staggered depreciation bonus which would give serious short-term incentives to accelerate new business investment.[11] Originally I proposed a 40% bonus that would fall to 20% in less than a year to encourage businesses to act quickly. Now that the 3-year 30% depreciation bonus has been passed, I believe it would be best to increase the amount of depreciation in 2003 to 45-50%, and have it fall to 20% in 2004. It would also be sensible to increase the 179 expansion limit for small businesses, but only in 2003. These changes may not make a significant difference for telecom and other companies with substantial excess capacity, but for the significant number of companies who are simply postponing investment out of uncertainty, such temporary measures will provide an incentive to accelerate investment into 2003 without significantly affecting expectations created by last year's tax changes.

3. **Target One-Time Assistance to Those Most Likely To Spend:** For some time, I have proposed a refundable tax cut on payroll taxes to provide targeted short-term stimulus. There are various ways in which this could be done, but the key is to get the funds out quickly to those with highest propensity to spend, and to avoid out-year deficit costs.

4. **Unemployment Extension:** By the same rationale, unemployment benefits should not only be extended but also expanded to the more than one million workers who already exhausted their benefits under the original extension and who are among the most likely to spend new resources.

[10] Orszag, Peter and William Gale, "The President's Tax Proposal: Second Thoughts," *Tax Notes*, January 27, 2003, p. 605.
[11] Sperling, Gene, "Business Incentives Must Get Small Stuff Right," *Bloomberg News*, October 18, 2001.

*D. Framework for a Potential Compromise*

1. **Agree quickly on a mix of Administration and Democratic Stimulus measures with no out-year deficit costs**: Several of the Administration proposals – doubling the child tax credit, increasing Section 179 expensing to $75,000 – could be merged with Democratic proposals for a one year increase in the depreciation bonus, expanded unemployment insurance and refundable family tax credits. The test would be both efficiency and a lack of out year deficit costs;

2. **Consider policies with long-term deficit projections at a later time in the year as part of overall budget process**. Policies with long-term deficit costs – from tax cuts to expanded prescription drugs – could be debated within a long-term budget framework in which the overall long-term costs of all proposed policies could be examined as well as potential measures for long-term savings. This would not force anyone to "give up" on their proposals, but would serve two purposes: one, it would ensure that long-term fiscal policy is being considered in a rational, comprehensive manner, in which the long-term trade-offs are transparent; two, it would prevent controversial long-term measures such as the exclusion of dividend taxation for individuals from stalling a stimulus plan from passing when it is most needed and while it can still be most effective.

## III. Policies to Lay Foundation for Long-term Growth

As mentioned at the outset, the most important task for policymakers is to promote policies that strengthen the long-term fundamentals of our economy. Such policies must aim to promote a strong long-term investment climate; protect our economy's dynamism and spirit of innovation, promote competition and productivity, and ensure that all of our people have a chance to both contribute to and benefit from our growth and wealth creation process. Such fundamentals are to my mind best promoted when we show commitment to long-term fiscal responsibility to promote savings and long-term confidence; promote open markets that spur exports, provide low prices for our families, inject competition into our economy; and target our federal resources to improving the skills and productivity of our people, rewarding work, providing opportunities for wealth creation for those most hard-pressed, and promoting the basic research that not only saves lives, but as Bill Gates Sr. recently said, provides a gift to future entrepreneurs.

Today, I will focus on one of those fundamentals: the importance of long-term fiscal responsibility. The recent effort by the current Administration to downplay the benefits of fiscal discipline are hard to understand based both on economic fundamentals and on recent economic history.

If I were giving this testimony a few years ago, I would focus mostly on what I believed were the best measures to achieve fiscal discipline and would not have felt compelled to make the case for why fiscal discipline matters. Indeed, during the mid 1990s, the debate centered on the best path to achieve fiscal discipline, rather than whether or not the policy mattered at all. Yet, while this Administration calls for restraint of non-defense and non-homeland security spending, it has challenged the very significance of long-term deficit and surplus projections to our economic health. For that reason, I would first like to address three misconceptions promoted by the Administration before turning to the positive case for continued fiscal discipline.

***Misconception One: Since Short-Term Deficits are Justifiable, So Too Are Long-Term Deficits.***

Basic Keynesian economic theory dictates that, in a slow economy, it makes sense to use temporary tax cuts or spending increases to boost spending. So when policymakers say we should not worry about a temporary rise in the deficit in a time of economic weakness or war they are right. But the crucial words are "temporary" and "time of economic weakness or war". Unfortunately too many commentators misrepresent this Keynesian logic to suggest that it would be wrong to worry about current policies that may be imposing trillions in long-term costs. The need for a temporary rising deficit to boost

demand and prevent a downward cycle does not in any way diminish the importance of long-term fiscal discipline. Likewise, when one is injecting fiscal demand in a period of economic weakness, there is nothing illogical or Hoover-like in being concerned with the long-term fiscal discipline.

***Misconception Two: Deficits Do Not Affect Interest Rates***

The Administration's virtual campaign to downplay the economic significance of raising long-term deficits is a sharp turn from the bipartisan mainstream consensus that existed even just a few years ago. Consider the sharp divergence of recent statements of the current Chairman of the Council of Economic Advisors with the previous statements of his predecessors under the past two Republican administrations:

- **Reagan Council of Economic Advisers under Chairman Martin Feldstein:** "Measures to reduce the budget deficit would lower real interest rates and thus allow the investment sector to share more fully in the recovery that is now taking place primarily in the government and consumer sectors."[12]

- **Bush I Council of Economic Advisers under Chairman Michael Boskin:** "Economic theory and empirical evidence indicate that expectations of deficit reduction in future years, if the deficit reduction commitment is credible, can lower interest rates as financial market participants observe that the government will be lowering its future demand in the credit market... In other words, expectations of lower interest rates in the future will lower long-term interest rates today. Lower long-term interest rates will reduce the cost of capital, stimulating investment and economic growth relative to what would be predicted if expectations were ignored."[13]

- **Bush II Council of Economic Advisors**:
  - "As an economist, I don't buy that there's a link between swings in the budget deficit of the size we see in the United States and interest rates…There's just no evidence."[14]
  - "I hope that the discussion will move away from the current fixation with linking budget deficits with interest rates. This linkage does not make a great deal of sense in a world in which global capital markets move trillions of dollars, and federal borrowing is only one – and far from the primary – use of funds. Not surprisingly, the evidence is that long-term interest rates do not move in lockstep with actual or expected federal budget changes."[15]
  - "We have very little empirical evidence to suggest much of a link between deficits and interest rates."[16]

The surprising campaign against the significance of deficits has been presented as reflective of academic literature that according to such advocates is uncertain at best as to the link between deficits and interest rates. This position is simply unfounded. First, as Brookings economists Peter Orszag and Bill Gale have correctly noted, the right question is not how current deficits affect current interest rates, but rather how the *expectations of future deficits* affect current rates. One might perhaps find that a belly-up company's stock price is not dramatically affected on the day it technically goes into court to file for bankruptcy. Yet no one would suggest that the expectation that a once-healthy company is going bankrupt does not dramatically affect stock prices. Likewise, when one focuses on the expectations of deficit changes, one not surprisingly finds a clear link between deficits and interest rates. For example, a new paper by three Georgetown economists presented at the 2002 Federal Reserve Conference in Jackson Hole,

[12] Economic Report of the President, February 1984, page 62.
[13] Economic Report of the President, February 1991, page 64.
[14] Glenn Hubbard quoted in Stevenson, Richard, "Bush's Way is Clear to Press His Agenda for the Economy," *New York Times*, November 11, 2002.
[15] Remarks by Glenn Hubbard at *Tax Notes* 30th Anniversary, December 10, 2002.
[16] Glenn Hubbard quoted in Stevenson, Richard, "On Tax Cuts and Deficits, a Battle of Believers," *New York Times*, February 10, 2002.

Wyoming found that an increase in CBO deficit projections of 2% of GDP increased long-term interest rates by over one percentage point.[17]

Indeed, a recent comprehensive review of the deficit-interest rate literature by Brookings Economists Peter Orszag and William Gale found that 16 of the 17 academic studies that looked at the effect of expected deficits on interest rates found a clear and significant link. Furthermore, most of the world's top fiscal and economic experts, including Harvard's Martin Feldstein, current Treasury Undersecretary John Taylor, Federal Reserve Chairman Alan Greenspan, and his predecessor Paul Volker have all explicitly written that deficits do indeed affect interest rates, and this fundamental relationship is built into the economic models used for decades under both Democratic and Republican Administrations at the Federal Reserve, the Congressional Budget Office and the Office of Management and Budget.[18]

Let me also say a word about recent statements suggesting that the current low nominal interest rates provide proof that deficits do not matter. This assertion ignores the demand side of the law of supply and demand. The fact that nominal rates are low in the current period of economic weakness when demand for capital is low is not surprising. What is important is whether they would have actually been lower absent the fiscal deterioration, and indeed there is evidence to suggest that long-term interest rates might have followed short-term rates even further down during substantial periods of the past two years, had the long-term deficit not been rising.

***Misconception Three: The Effect of the Administration's Policies on Long-Term Deficit Are Moderate.***

When the current Administration has been challenged on the notion that deficits do not matter, they have at times sought to modify their view by suggesting that the impact of their tax cuts are "moderate" and that such "moderate" changes in our fiscal picture have no significant economic impact. Yet there is nothing moderate about the recent swing in our fiscal position or the negative long-term impact of the administration's tax cut proposals. The CBO projected in January 2001 a ten-year surplus of $5.6 trillion, and now many experts are projecting a deficit of $1-2 trillion over the coming decade.[19] To paraphrase a former Member of Congress, $7 trillion here and there is still real money. Furthermore, when one adds up the cumulative impact of the Administration's tax policies, the negative impact would be more than $4 trillion over the coming decade (see table below).

**Cumulative Cost of the Administration's Tax Cuts**

| | Revenue Loss | Debt Service |
|---|---|---|
| New Administration "stimulus" proposal* | 670 | 250 |
| Remove sunset on 2001 tax legislation* | 615 | 50 |
| AMT reform (estimate)* | 550 | 100 |
| 2001 Tax Cut (EGTRRA)** | 1350 | 553 |
| **Totals** | **3185** | **953** |
| **Grand Total** | **4138** | |

Note: All figures are for the period 2003-2013, except the EGTRRA, which is from 2001-2013 including interest costs.
* Estimates from Friedman, Joel and Richard Kogan, "Full Cost Of Administration's Agenda For New Tax Cuts Is At Least $2.2 Trillion Through 2013" Center on Budget and Policy Priorities, January 25, 2003.
** Estimates based on "Why the Surplus Has Disappeared" Center on Budget and Policy Priorities, September 3, 2002.

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[17] Canzoneri, Matthew B., Robert E. Cumby, and Behzad T. Diba, "Should the European Central Bank and the Federal Reserve Be Concerned About Fiscal Policy?" *Paper Presented at the Federal Reserve Bank of Kansas City Annual Conference,* August 2002.
[18] Gale, William and Peter Orszag, "The Economic Effects of Long-Term Fiscal Discipline," *Urban-Brookings Tax Policy Center Discussion Paper*, December 17, 2002.
[19] Congressional Budget Office, *Economic and Budget Outlook: 2002-2012*, January 2001.

## IV. The Case for Continued Fiscal Discipline

Having set the record straight, it is fundamentally important for us to understand the importance of fiscal responsibility to the long-term performance of our economy. Below I outline seven ways in which fiscal discipline contributes to the type of sustained, shared economic growth we experienced in the 1990s.

### 1. Fiscal discipline increases national saving

The main contribution to our net national savings rate in the 1990s was an improvement in our fiscal position. Despite a declining rate of personal savings, The U.S. was able to nearly double net national savings over the course of the 1990s, from 3.4% in 1993 to 5.9% in 2000. This was accomplished by moving the federal government from a policy of dissavings and deficits of 4.1% of GDP to a policy of savings and surpluses of 2.1% of GDP -- a swing of 6.2% of GDP. By the end of the decade, the government was "crowding in" private sector capital by paying down debt and adding to the pool of capital available to finance productive investments. The increase in national savings during this period laid a foundation for the longest economic expansion in modern history.

### 2. Fiscal responsibility promotes a strong long-term investment climate through low interest rates and increased confidence

As described above, there is overwhelming evidence that fiscal discipline helps keep long-term interest rates down by increasing the pool of savings available to make investments, thus improving the long-term investment climate. Deficits, on the other hand, can crowd out future private investment. As Harvard's Martin Feldstein explains, "[A]n anticipated future budget deficit means a smaller amount of funds at that future date to finance investment in plant and equipment. Restricting that investment will require a higher real rate of interest. Similarly, the anticipated budget deficit means that individuals will have to be offered a higher yield in the future to induce them to hold the larger amount of government debt in their portfolios. Both of these effects raise the expected future interest rate and therefore…they raise the current long-term rate as well."[20]

Fiscal discipline also improves the investment climate by generating confidence in the U.S. economy. It was the opinion of all of the Secretaries of the Treasury in the Clinton Administration that fiscal discipline was an important component of the image of strength and stability that the U.S. economy projected to the rest of the world. That image led foreign investors to demand a smaller risk premium for investments in the U.S.

As Federal Reserve Chairman Alan Greenspan explains "returning to a fiscal climate of continuous large deficits would risk returning to an era of high interest rates, low levels of investment, and slower growth of productivity…history suggests that an abandonment of fiscal discipline will eventually push up interest rates, crowd out capital spending, lower productivity growth, and force harder choices upon us in the future."[21]

### 3. Fiscal discipline translates into real savings for the American family

The impact of fiscal discipline goes well beyond businesses and large investors, and has important implications for the average American family. For example, a middle-line estimate based on the Federal Reserve, Congressional Budget Office and other mainstream macroeconomic models suggests that the cumulative size of the Administration's proposed tax cuts -- measured by their projected impact on the ten-year deficit as a share of GDP -- would raise long-term interest rates by more than 200 basis points. This would not only seriously discourage new business investment and reduce the value of the stock market, it would also mean a $3000 increase in annual mortgage payments for a family holding a 30-year $200,000

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[20] Martin Feldstein, "Budget Deficits, Tax Rules, and Real Interest Rates," *NBER Working Paper No. 1970*, July 1986, page 13.
[21] Greenspan, Alan, "Current Fiscal Issues" Testimony Before the Committee on the Budget, U.S. House of Representatives, September 12, 2002.

mortgage.[22] That is more than the typical family would receive from the Administration's tax cut proposals over the long-term.

**4. Fiscal responsibility promotes a virtuous cycle of economic growth**

Some have suggested a simplistic dichotomy in the debate over fiscal policy -- either surpluses create growth or growth creates surpluses. Clearly the overall goal of fiscal policy is to encourage growth, not fiscal discipline for its own sake. But real question is: what fiscal policies lead to sustainable growth by helping to expand our economy's capacity, rather than running it up against an inflationary wall? A key lesson of 1990s was that fiscal discipline was critical to creating a virtuous cycle. By creating a larger pool of savings, fiscal discipline kept interest rates low for new investment, and because surpluses were being saved, additional capital was being provided just when investment demand was rising. The effect? According to a Goldman Sachs analysis in April 2000, "the swing in federal budget position from a deficit of $290 billion in 1992 to a surplus of $124 billion in 1999 - roughly matching the improvement in the general government position - has lowered equilibrium bond yields by a full 200 basis points."[23] This spurred productive investment that expanded capacity, and as growth and productivity picked up, we grew at rates not seen in decades as inflation stayed low. A substantial amount of this productivity growth appears to be lasting: productivity averaged only 1.4% annual growth from 1973 to 1995, but has averaged 2.25% from 1995 to 2001.

This virtuous cycle allowed for the longest productivity expansion in history, which has been sustained even at the end of the period of economic growth. While some of the investment in the end of the 1990s turned out to represent excessive optimism and herd investing, we should not underestimate the enormous benefits of such a long and sustainable expansion. The unemployment rate fell to its lowest levels since 1969. Wage growth, which had been stagnant for decades, recommenced. In 2000, the share of the population living in poverty fell to its lowest rate since 1974.

To be sure, fiscal discipline is not a silver bullet; other factors contributed to the positive economic developments of the 1990s. However, fiscal discipline was a critical element in fostering the environment that allowed the growth of the 1990s to be strong and sustained. As Chairman Greenspan has stated, "[t]he lower federal deficits and, for a time, the realization of surpluses contributed significantly to improved national saving and thereby put downward pressure on real interest rates. This, in turn, enhanced the incentives of businesses to invest in productive plant and equipment."[24]

**5. Fiscal discipline is the key element in generational responsibility**

For years in the late 1990s there was bipartisan and widespread support for the idea that we should save surpluses to meet the baby-boom retirement challenge without passing on the burden to the next generation. A key component of this generational responsibility is to adopt policies that increase savings to spur long-term productivity so that a smaller number of workers can support the larger number of future retirees without oppressive tax increases or spending cuts. Another imperative is to make sure that there are funds available to finance the transition costs required to make most Social Security reform plans more viable.

Nothing has happened in the last two years to suggest that Social Security and Medicare require less national savings and less generational responsibility. Yet we no longer have the bipartisan commitment. Instead of saving for the next generation, we have passed large, consumption oriented tax cuts that will increase the burden on our children and grandchildren. Over time, the loss in revenues

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[22] Estimate based on Gale, William and Peter Orszag, "The Economic Effects of Long-Term Fiscal Discipline," *Urban-Brookings Tax Policy Center Discussion Paper*, December 17, 2002.
[23] Goldman Sachs, GSWIRE Undistorted by the Budget Surplus, April 14, 2000.
[24] Greenspan, Alan, "Federal Reserve Board's semiannual monetary policy report to the Congress" *Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate,* July 16, 2002.

associated with the Bush Administration's tax cut proposals is two- to three-times the amount needed to cover the 75-year shortfall in Social Security.[25]

**6. Fiscal responsibility prepares us to deal strongly with economic downturns**

As I have explained, it makes eminent sense to run deficits during a recession in order to jumpstart the economy. But this cannot be seen as an excuse to abandon long-term fiscal discipline. It is important to realize that policies of long-term responsibility are themselves critical to giving us the flexibility to run temporary deficits for stimulus or national security reasons without significant negative consequences. Because of previous commitments to save surpluses, the recent dramatic shortfall in revenue and use of fiscal stimulus left us with a deficit in 2003 of only 1.5% of GDP -- as opposed to a projected surplus of $300 billion, or 3% of GDP. Had we gone into this period with policies that tolerated even relatively small deficits, this swing could have driven deficits this year to $500-600 billion, or 5-6% of GDP, which would have been among the biggest since WWII. Simply put, long-term fiscal discipline gives us the flexibility to unload both our fiscal and military cannons without driving us into a precarious fiscal situation.

**7. Fiscal responsibility helps us meet new and old challenges**

Clearly, fiscal discipline must always be balanced with the need to address our nation's new and lingering challenges. Yet if we are to be able to meet new spending challenges in homeland security as well as lingering problems of child poverty, educational inequity, and AIDS both here and in the world's poorest countries, we must choose wisely, so that we do so in the overall context of long-term fiscal discipline.

## V. Policy Implications: We Need a Pro-Growth Grand Bargain

What is needed is a pro-growth grand bargain that addresses both the short-term and the long-term. On the long-term side, there is no question that a commitment to fiscal discipline will require mutual sacrifice. President Bush needs to begin the politically difficult process of bringing all parties together to work out a bipartisan compromise. A pro-growth grand bargain will not require raising taxes but it will require the President being willing to put his own priorities on the table to give him the moral standing to ask others to do so as well.

My personal proposal for such a grand bargain would go as follows: The President and Congress would start by agreeing to a $100-$150 billion stimulus that would draw on ideas from both parties – as long as they had a high bang for the buck and did not have out year deficit costs. Next, the President would guarantee that while Americans would continue to get tax relief, new rounds of tax cuts that only affect those making over $150,000 would be frozen. As I have described elsewhere,[26] this savings alone would be enough to close 53% of Social Security's 75-year insolvency gap. Congress, on the other hand, would agree to hold back on excessive new entitlement costs – including for prescription drugs. Such a pro-growth grand bargain would show our citizens as well as world investors that even as we continue to defend our homeland and strive for greater hope and opportunity, the era of fiscal responsibility is not over in the United States.

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[25] Orszag, Peter, "The Administration's Economic "Stimulus" Proposals," *Testimony Before the Democratic Policy Committee,* January 22, 2003.
[26] Sperling, Gene "Fiscal Chutzpah," *Washington Post*, July 31, 2001.