TESTIMONY OF ROBERT GREENSTEIN

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before the
HOUSE BUDGET COMMITTEE

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I appreciate the invitation to testify before the Committee. I am Robert Greenstein, director of the Center on Budget and Policy Priorities, a policy institute that specializes in fiscal policy as well as in policies related to low- and moderate-income families. The Center does not, and never has, received any federal grants or contracts.

I would like to start with some observations about the importance of taking business cycles into account when evaluating fiscal policy options. The economy always grows — and revenue always increases — during economic recoveries and periods of normal economic growth. Sometimes this may lead to mistaken assumptions that certain policies whose adoption coincided with the start of a recovery *caused* the recovery or the resulting revenue growth. Thus, a claim is often made that the tax cuts enacted at the start of this decade caused the recovery and the revenue growth of recent years, or at least made the growth much greater than it otherwise would have been. The same logic, however, could be used to argue that the tax *increases* enacted in 1990 and 1993 caused the boom of the 1990s. Neither claim is especially credible.[1] I also would note that during the recovery of recent years, which now appears to be ending, both economic and revenue growth were actually slower than during the recovery of the 1990s, and also slower than the average for comparable business-cycle periods since the end of World War II. That further weakens the case that the tax cuts of 2001 and 2003 spurred strong growth.

Issues related to economic cycles are important again at the present time, as we think about appropriate measures to stimulate the economy and keep it out of recession (or to prevent a recession from becoming more severe). This is because the types of policy measures that are needed to stimulate the economy in the short term are very different from the policies one would want to pursue to improve prospects for long-term growth.

For the long term, we need more saving and less consumption, policies to avert the persistent, large deficits that loom in future decades, and appropriate investments in things that can boost productivity such as education, basic research, and infrastructure. In contrast, what we need now is to keep consumption as strong as possible, rather than to increase saving. And various investments and other policies that may be useful for long term growth will not constitute effective stimulus in the short term, unless they inject increased demand into the economy quickly.

Similarly, while ongoing tax cuts and entitlement increases should be fully paid for, it would not make sense to offset temporary stimulus measures by cutting programs or raising taxes in the same year, since doing so would diminish the stimulus effects.

[1] As Robert hall of the Hoover Institution has noted, "The U.S. economy recovered from every single recession it ever had, so the growth in 2003-2006 was generally part of the normal cyclical recovery." See Daniel Altman, "Did the Tax Cuts Bolster Growth?," *New York Times*, May 13, 2007.

What Should We Do Now?

So what should we do now to stimulate the economy? As Martin Feldstein told the Senate Finance Committee last week, "In the current context, in an economy where there's extra slack… we really do want to increase consumer spending."

The primary consumers are U.S. households. They are not the only consumers, however. Businesses and governments buy goods and services as well. We should pay attention to all three.

Household Spending

As the Congressional Budget Office and other economists have noted, stimulus measures that put more income into people's pockets are more effective when focused on low-income households, and less effective when focused on high-income households. This is because people who live paycheck to paycheck tend to spend, rather than save, nearly all of their added income, while those at high income levels would tend to bank much of it. Analyses of the 2001 tax rebates show that lower-income households spent a larger share of their rebates than affluent households did.

This suggests that House leaders made the right decision last week when they included most low-income working families in the tax rebates that they designed. Excluding such families would have made the rebate significantly less effective as economic stimulus. A recent analysis by Moody's Economy.com estimates that a rebate that fully includes such families would be 24 percent more effective as stimulus than a rebate that excludes these families (generating $1.26 in increased economic activity per dollar of cost, as compared to $1.02 for a rebate that leaves these families out).

This also points, however, to a shortcoming in the rebate design. Under the agreement announced last week, working-poor families would receive considerably smaller rebates than more well-off families. Thus, a mother with one child who works full time at the minimum wage and makes less than $12,000 would receive a rebate of $600, while a married couple making $150,000 would receive a rebate of $1,200 — or twice as much. The rebates would be more effective as stimulus if the rebate amounts were uniform, with the rebates that working-poor families receive being the same size, rather than smaller, than the rebates going to families at higher income levels.

Two Missing Components

One limitation of the rebates is that they will take some time to work. The first rebate checks apparently can not go out until late May, and many families will not receive their rebates until July or possibly early August. Yet the reason that House leaders and the Administration sought to move so expeditiously was to inject increased demand into the economy quickly.

Therefore, I believe it was a mistake to drop the only two provisions that most experts agree would be *both* highly effective as stimulus *and* fast-acting — the provisions related to unemployment insurance and food stamps. In CBO's recent report on stimulus options, the unemployment insurance and food stamp options are the *only* items that receive CBO's top rating in *all three* of CBO's categories for evaluating the various options. CBO found that these two options would:

- have "*large"* effects in generating increased economic activity per dollar of cost;
- entail only a "*short*" lag between enactment and the time by which the policy has achieved the

bulk of its stimulative effect; and

- carry only a "*small*" degree of uncertainty as to the policy's stimulus effects.

No other tax or spending option received CBO's top rating in even two of the three categories, let alone all three.

A number of private financial analysts have reached similar conclusions. In an analysis issued Friday, Goldman Sachs essentially made these same points and counseled that temporary increases in UI and food stamps have "strong policy justifications" as stimulus.[2]

Similarly, an analysis issued last week by Moody's Economy.com, which examined the effectiveness of various stimulus options, gave its highest rating for effectiveness to the food stamp and UI options. The analysis found that:

- A temporary increase in food stamp benefits would generate *$1.73* in increased economic activity for each $1 in cost.

- Extending unemployment benefits so workers' benefits do not run out before they find a new job would be the second most effective measure, generating *$1.64* in increased activity per dollar of cost.

- By comparison, tax rebates that fully include low- and moderate-income working families would generate $1.26 in increased economic activity per dollar of cost.

- And the principal business tax cut in the new stimulus package — a proposal to accelerate the depreciation write-offs that firms take — would generate 27 cents in increased economic activity per dollar of cost.

There are two reasons why the UI and food stamp provisions rate so highly as stimulus. First, these provisions would help people who either have very low incomes and are extremely cash constrained, or who otherwise face a precipitous decline in income because they have lost their jobs and now face the expiration of their unemployment benefits (and may cut their consumption sharply as a consequence). Because the food stamp and UI provisions are targeted on these groups, most of the resources that these provisions would provide to families would be spent quickly. The second reason these provisions rate highly is that they can be implemented rapidly.

Take food stamps as an example. Food stamp households are poor — 90 percent of them live in poverty — and research has found that about 80 percent of food stamp benefits are spent within two weeks of a household's receiving them. Some 97 percent of the benefits are spent by the end of the month. Furthermore, an increase in food stamp benefits can be implemented in 30-60 days after enactment, depending on the state.

There also is a point about unemployment benefits worth noting. The *long-term* unemployment rate — the percentage of people in the workforce who have been unemployed for at least 26 weeks and are still looking for work — was nearly twice as high in the last quarter of 2007 as it was immediately before the 2001 recession. This is significant both because it is the long-term

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[2] Goldman Sachs, "Refilling the Punch Bowl: The Prospects for Fiscal Stimulus," Jan. 25, 2008.

unemployed who reduce their consumption the most and because stimulus measures that provide additional weeks of unemployment benefits are targeted on this group.

Businesses

Businesses make purchases, as well. They also hire or fire workers. The effect on the business sector is crucial.

There often is misunderstanding, however, about which federal policies are most effective in maintaining business purchases and employment when the economy weakens materially. The primary factor in such circumstances is *not* the cash that businesses have on hand; it is whether customers are spending money and buying their products.

A business with ample cash to spend (whether through profits, savings, or government tax incentives) will *not* spend more, or refrain from laying off workers, if there is not sufficient demand for its products. Demand is a far more important factor than cash on hand in the employment and investment decisions of firms that see their responsibility as making profits for their shareholders. A firm that retains workers whom it does not need to produce the goods and services it can sell is essentially wasting its money and failing to fulfill its responsibility to its shareholders.

As Goldman Sachs explained in an analysis last fall, "companies don't spend money just because it's there to spend. To justify outlays for new projects, the expected returns have to exceed the costs, and that usually requires growth in demand strong enough to put pressure on existing resources."[3]

As a result, the single most effective way to maintain business spending and hiring is to maintain consumer demand. The tax rebate, unemployment insurance, and food stamp measures discussed above would all serve this goal.

In contrast, business tax incentives tend to be less effective as stimulus, as CBO and other analysts have pointed out. A temporary investment incentive targeted to *new* investment (as distinguished from investments that have already been made) may provide some stimulus in situations where weakness in the economy is causing firms to postpone positive planned investments — if the incentive succeeds in inducing firms to accelerate their investment plans. But the stimulative effects of such incentives are likely to be considerably more modest than the effects of measures that put the same amount of money in the pockets of households that will spend it, because a substantial share of the investment spending subsidized through the tax incentives — even if limited to new investments — will be investment that would have been made anyway.

This is borne out by the leading study that examines the effects of the "bonus depreciation" tax incentives that were enacted in 2002 and 2003 to provide stimulus during the last recession. The study, by Federal Reserve economists, found that bonus depreciation had, at best, "only a very limited impact" on investment spending. Similarly, as noted earlier, Moody's Economy.com estimates that bonus depreciation, the principal business tax cut in the new stimulus package, would generate only 27 cents in increased economic activity per dollar of cost.

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[3] GS Weekly, September 21, 2007.

Governments

The actions of governments, as well, affect aggregate demand in the economy. Government actions that raise taxes or cut payments to beneficiaries or to firms or agencies that provide services reduce aggregate demand. When such actions are taken during an economic downturn, they make the downturn deeper.

No federal policymaker would think of raising taxes now or paying for a stimulus package with contemporaneous tax increases or spending cuts. Yet we are headed for large budget cuts and tax increases at state and local levels. Those actions will be a drag on the economy. They will offset the positive effects of a significant portion of the federal stimulus package.

Unlike the federal government, state governments (except Vermont) are required by their own laws or constitutions to balance their budgets every year, even during recessions. As a result, states cut programs and raise taxes in recessions. This decreases the amount of money that people have to spend or that the state spends, and thereby makes the downturn deeper.

As of last week, 25 states were reporting budget deficits for fiscal year 2009, which starts July 1 in most states. This number is rising almost daily, as governors release their budgets and issue new budget estimates. We expect that within a few weeks, as more states issue new budget forecasts, at least 30 states will be facing deficits.

Of the 25 states that have released new budget estimates and are projecting deficits, only 18 have issued specific deficit estimates to date. In these 18 states alone, the projected deficits total nearly $32 billion. This figure will rise much higher as budget data become available for all states.

This means that large state budget cuts and tax increases are in store. Two states have already enacted substantial tax increases to help close projected deficits. Governors and legislative leaders in a growing number of states are proposing hefty budget cuts, ranging from eliminating health care coverage for thousands of low-income children and elderly individuals to slashing funding for education, child care, and other basic services. When recession hits, health care, education, and aid to local governments are typically the three principal parts of state budgets that absorb the bulk of the cuts. In the last downturn, for example, state Medicaid cuts led to the loss of health care coverage for up to 1 million low-income people.

Moreover, an unusual circumstance is making the current fiscal situation even more troublesome for many states. Many local governments are facing falling property tax revenues because of declining home values and are turning to their state governments for help, so that they do not have to institute overly severe cutbacks in basic services like schools, police, and firefighting. This is intensifying the pressure on state budgets.

This strongly suggests that the federal government should provide some fiscal relief to states, whether in the current stimulus package or through another vehicle, as it did in the last recession. Lessening the degree to which states institute contractionary budget cuts and tax increases should be an important part of the federal response to the deterioration in the economy.

Moody's Economy.com on State Fiscal Relief

"Because most state governments are required by their constitutions to quickly eliminate their deficits, most are already drawing up plans to cut funding for programs ranging from healthcare to education and cutting grants to local government. Local governments are having their own financial problems; most rely on property-tax revenues, which are slumping with house prices. Cuts in state and local government outlays are sure to become a substantial drag on the economy later this year and into 2009.

"Additional federal aid to state governments would fund existing payrolls and programs and so provide a relatively quick economic boost. States that receive a check from the federal government will quickly pass on the money to workers, vendors and program beneficiaries.

"Arguments that state governments should be forced to cut spending that has grown bloated and irresponsible are strained at best. State government spending and employment are no larger today as a share of total economic activity and employment than they were three decades ago. Moreover, arguments that helping states today would encourage more profligacy in the future also appear overdone."[1]

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[1] Mark Zandi, "Washington Throws the Economy a Rope," January 22, 2008, available at http://www.economy.com/dismal/pro/article.asp?cid=102598

Unfortunately, the current stimulus package would actually make this problem worse. The bonus depreciation tax provision it contains will cause some 30 states to lose $4 billion in tax revenue, due to linkages between federal and state tax codes that the majority of states have adopted to promote simplicity. This will compel states to institute bigger increases in other state taxes or steeper budget cuts, which is a harmful outcome from a stimulus standpoint.

Two arguments are sometimes heard against fiscal relief. One is that some states are not in economic or fiscal difficulty. CBO has observed that fiscal relief which lessens the severity of state budget cuts or tax increases *is* stimulative, but fiscal relief provided to states not facing deficits is not.

This concern can be addressed by targeting relief on states facing economic and fiscal difficulty. That can be done by using such measures as data on state-by-state changes in employment, food stamp caseload, and foreclosures. These data can be used to develop mechanisms that target relief on states whose economies (and budgets) are in trouble.

A second question is whether, if the federal government provides aid to states in a recession, this creates a "moral hazard," in which states then respond during periods of solid economic growth by overspending, cutting taxes too much, or failing to build up "rainy day" funds and thereby exacerbating the fiscal problems they face in the next downturn because they are counting on the federal government to bail them out. The evidence strongly indicates that modest amounts of federal fiscal relief during recessions do *not* have this effect.

The federal government provided $20 billion fiscal relief in the last downturn. The data show that states have not overspent or slashed taxes since then in the expectation they would be bailed out during future downturns. On average, state expenditures as a share of the economy are *lower* now than they were in state fiscal year 2001, while state taxes as a share of the economy are at about the same level. In addition, once the recession ended, states built up substantial "rainy day" reserve

funds to draw upon in the next downturn; at the end of 2006, those reserves were actually a little *larger*, as a share of annual state expenditures, than before the recession at the start of this decade. In short, the provision of fiscal relief in the last downturn was not followed by irresponsible actions on the states' part.

Although states built up substantial revenues (or rainy-day funds) before both the last recession and the impending one, recessions have such large effects on state budgets that they wipe out reserves and produce sizeable shortfalls. States began this decade with reserves equaling 10.4 percent of annual expenditures, a very substantial amount. Yet those reserves closed only about one-quarter of the state budget gaps that opened up through state fiscal year 2003.

Moreover, a recession now could have especially large effects on state and local revenues because of the effects of declining home values in causing property tax revenues to erode. In contrast, home values and property tax revenues held up during the last recession.

To be sure, it is quite possible that federal fiscal relief could create a "moral hazard" problem if it filled most or all of the state budget gaps that emerged during a recession. Relief of that magnitude, however, is not what anyone is talking about. The $20 billion in federal fiscal relief provided in 2003 closed only about 10 percent of the state budget shortfalls that emerged when the economy was weak in the early years of this decade. Today, the governors, on a bipartisan basis, are seeking a quite modest level of relief — $12 billion.

Moving Beyond Ideology and Focusing on Stimulating the Economy

The task now is to focus laser-like on what would, and would not, be effective stimulus. Consideration of what will be good for the economy over the long term remains important. But that is a separate discussion — and should involve a separate set of decisions — from what is needed to provide effective stimulus now.

This means that certain nostrums need to be set to the side. For example, some people assume that tax cuts are inherently more stimulative than spending measures, but that assumption does not bear up well under scrutiny. As an array of distinguished economists (whose ranks include Nobel laureate Joseph Stiglitz, now-CBO director Peter Orszag, and Federal Reserve economists) have noted in the past, some spending measures and tax cuts can provide effective short-term stimulus, while other spending measures and tax cuts are ineffective as stimulus. Each measure needs to be evaluated on its own merits as stimulus. Simply labeling an option as "spending" or "tax" tells little.

The current process of developing a stimulus package is off to a promising start. It is my hope that in short order, an effective package will be enacted that both builds — and improves — upon the bipartisan package unveiled last week.