The Budget and the Economy

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Mr. Chairman, Senator Domenici, and Members of the Committee, I am pleased to be here today to discuss issues surrounding the economy and the federal budget. I would like to emphasize that I speak for myself and not my employer, Griffin, Kubik, Stephens & Thompson, Inc.

The past year has witnessed some dramatic changes in the economy, the budget and monetary policy. After expanding for 120 consecutive months, the longest period of sustained growth in U.S. history, the economy entered recession in March 2001. In reaction to the slowdown, the Federal Reserve cut interest rates eleven times in 2001, the sharpest drop in rates in over 40 years.

In addition, both short-term and long-term estimates of the budget surplus underwent significant revisions. In May 2001, the Congressional Budget Office estimated that the surplus for 2001 would equal $275 billion. Just four months later, the figures show that the actual surplus was $127 billion. At the same time, expected surpluses of over $300 billion in 2002 and 2003 have given way to certain deficits. The recession, higher spending, and tax cuts reduced the 10-year estimate of the budget surplus from $5.6 trillion to $1.6 trillion.

Analyzing these developments individually is impossible. The economy, the Federal Reserve and the budget are inseparably intertwined. The economy affects monetary and fiscal policy, while monetary and fiscal policy exert a large influence on the economy.

For example, according to CBO analysis, the recession will reduce revenues and increase expenditures by a total of $148 billion in 2002 and $131 billion in 2003. At the same time, the CBO estimates that deficits will equal $21 billion in 2002 and just $14 billion in 2003. Clearly, the economy would have experienced surpluses in both years if the recession had not occurred

The Causes of the Current Recession

As a result, it is important to understand how the recession began. In this regard, there are at least four different explanations of the current downturn. Some suggest that it is a simple inventory correction made worse by the attacks of September 11. Others suggest that our current recession is the result of a bursting bubble of irrational exuberance and over-investment.

Still others suggest that the tax cut of early last year, because it lowered the surplus and drove up interest rates, either caused the recession or made it worse. Finally, there are some who think that the recession was caused by policy mistakes. I include myself in this final group. High taxes and excessively tight monetary policy in 2000 are the real culprits behind our current economic downturn. In fact, it was the impact of these policies that led to my forecast in January 2001 that the U.S. would experience its first recession in ten years.

In 2000, the Federal Reserve increased real interest rates to their highest level since 1989/1990. High real interest rates were the visible evidence of an excessively tight monetary policy that created deflationary pressures. These deflationary pressures, evident in so many industries, undermined corporate profits and investment. At the same time tight money was creating havoc, federal revenues rose to 20.8% of GDP in 2000, a peacetime record.

History shows that the combination of tight monetary policy and burdensome taxes eventually creates a recession. This was true in 1990/91, in the early 1980s and also in Japan during the 1990s. High taxes reduce the capital available for investment, undermine incentives for research and development, and reduce output, while tight money robs the system of liquidity.

Characteristics of the Recession

Industrial production peaked in June 2000 almost a year before the recession officially began and well before the tax cut passed in May 2001. Employment peaked in March 2001 also well before the tax cut. Consumption slowed sharply in late 2000 and early 2001, but did not dip into negative territory until late 2001. Interestingly, housing activity remains very strong and existing homes sold at a record level in 2001.

The areas of weakness and strength in the economy during the past year are somewhat instructive. Consumption did not fall as much as rising unemployment suggested it should because counter-cyclical policies worked. Unemployment insurance kept incomes from falling to zero and tax rebates added to near-term purchasing power. In addition, large, privately funded severance packages for many of those laid-off early in the recession kept incomes from falling.

Strength in housing is a different story. Housing is one of the only tax-free investment vehicles available to Americans today. Due to changes made in the tax code in 1997, up to $500,000 in gains on the sale of a home, for a couple who has lived in that home for two years or more, are tax free. Mortgage interest is deductible from taxes as well. Beginning in May 1997, new and existing home sales shot upward and have literally defied demographic trends. Judging from this evidence is can be said that tax cuts do increase economic activity.

To summarize, the recession was not caused by tax cuts, a bursting bubble, a drop in consumer confidence due to terrorist attacks, or an inventory correction. It was caused by policy mistakes, specifically, high taxes and an excessively tight monetary policy. In turn, the recession created our budget deficits.

Focus on Growth, Not Deficits

Growth is the key to all budgetary and economic problems. And, in my opinion, historical evidence shows that countries with lower taxes and less spending grow faster than countries with high taxes and large governments. I believe the goal of fiscal policy should be to maximize the potential of the private sector to create jobs and wealth. And even if the ultimate goal is to eliminate federal deficits and debt, the best way to achieve that goal is by encouraging growth.

Historically, in periods of recession or war, economists have suggested that deficits are appropriate. In laymen's terms, running a deficit (or borrowing money) is an investment in the future of the economy. If that investment keeps our nation safe from foreign attack or ends a recession, then the returns from that investment should outweigh the costs. However, in recent decades many economists have suggested that deficits have a detrimental effect on the economy because they push up interest rates.

Despite the near universal acceptance of this theory, I find no evidence to support it. During the past 20 years, the federal budget has moved from record deficits to record surpluses, but interest rates have not moved in the direction suggested by the deficit theory. For example, in January 1981, when Ronald Reagan became President, 30-year mortgage rates were 14.9%. Twelve years later, when George Bush left office and Bill Clinton became President, the 30-year mortgage rate was 8.0%. The economy experienced deficits in each of those twelve years, yet mortgage rates fell by a total of seven percentage points.

When Bill Clinton left office in January 2001, the 30-year mortgage rate was 7.0% a decline of just one percentage point during his eight-year tenure. This small drop pales in comparison to the declines of the 1980s, despite record budget surpluses. The evidence suggests that there is no relationship between budget deficits and interest rates over long periods of time. (See Chart #1).

The same is true if we analyze real (or inflation adjusted) interest rates. Between 1981 and 1983, budget deficits average 3.1% of GDP and the real 30-year mortgage rate averaged 8.0%. In 1993, the deficit was 3.9% of GDP and the real 30-year mortgage rate was 4.0%. In 2000, when the surplus reached a record 2.4% of GDP, real 30-year mortgage rates were 5.6%. And, in 2001, as the budget moved toward deficit, real mortgage rates fell back to 4.0%. (See Chart #2).

Tax Cuts Are Key

Economic growth rates also show little correlation to movements in the deficit. The U.S. economy rebounded strongly from the early 1980s recessions even though deficits were high, and real GDP grew at a 4.4% annual rate between 1982 and 1987. Between 1995 and 2000, despite moving from deficits to surpluses, real GDP grew at a slower 4.1% rate. In addition, the economy fell into recession in early 2001 despite a budget surplus.

The driving force behind growth in both the 1980s and 1990s was the same – high-tech investment and productivity. And, in my opinion, the shift in government policy that began during the late 1970s and accelerated in the early 1980s was the catalyst behind our long boom. Reduced marginal income tax rates, lower capital gains tax rates, and falling government spending as a share of GDP created a better environment for entrepreneurial success. As a result, the United States became the focal point of the information revolution and we have experienced to of the longest recoveries on our history during the past 20 years.

In fact, it has been over 100 years since the U.S. experienced productivity growth as strong as we have seen in recent years. And according to my calculations, productivity growth reached higher levels in the late 1990s than it did in the Industrial Revolution. More importantly, the world is just beginning this revolution in technology. It has a long way to run.

Anything the government can do to help increase incentives for creativity, innovation and investment will pay huge dividends down the road. In that regard, it is my advice that tax rates be kept as low as possible, spending increases should remain minimal and any concerns over the deficit should wait until after the U.S. exits this recession and has a chance to grow again.

The Bush tax cuts of 2001 were perfectly timed to help the economy in the years ahead. However, because they were phased in over a decade-long period they have only been a small help to the economy in the past year. It is my strong belief that the economy would already be in recovery if the Bush tax cuts had been fully effective in 2001.

But that is water under the bridge, and we must look forward. Repealing the tax cut would be a huge mistake and could undermine the recovery already taking hold. I expect this recovery to start out slower than past recoveries, but build steam as 2002 unfolds. In 2003, the economy should once again grow at a 4.0% rate or higher. Unemployment will fall, tax revenues will pick up, counter-cyclical government spending will subside and the budget picture will brighten.

In other words, despite the mistakes made in the past year, the economy remains on sound footing. As taxes head lower, foreign investment will continue to flow toward the U.S., technology will continue to advance and living standards will rise.

We are living through an exceptional period in history, and we should attempt, as best we can, to have faith in the American system of free markets. The entrepreneurial spirit remains strong and as history shows, the less the government interferes, the better. In fact, doing everything possible to reduce burdens on the private sector increases growth, and in turn, boosts the resources of government. What creates growth in the private sector is ultimately good for the public sector.

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Chart #1

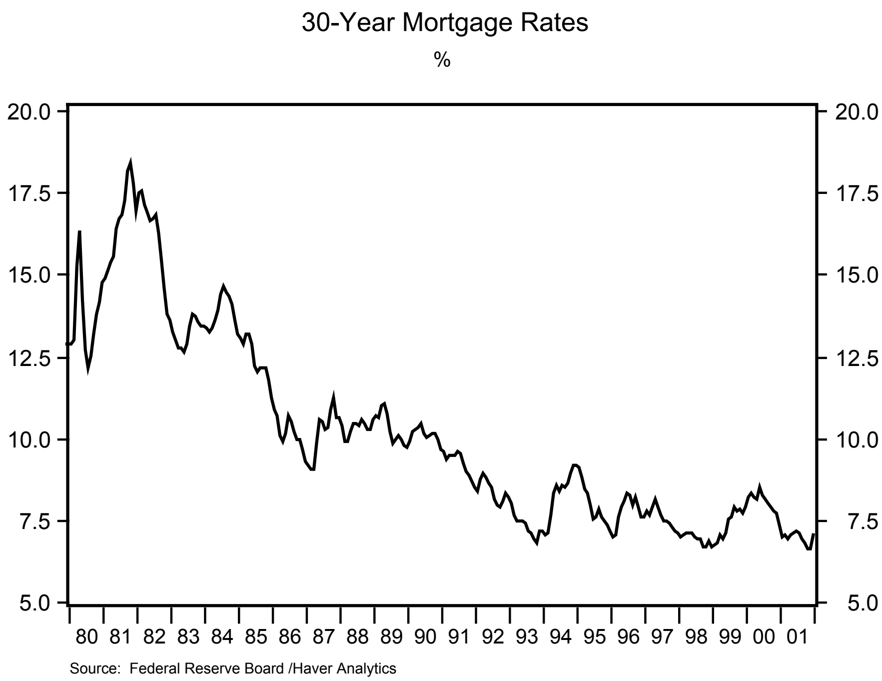

Chart #2