CBO TESTIMONY

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

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NOTICE

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CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON,D.C.20515

Mr. Chairman and Members of the Ways and Means Committee, I appreciate this opportunity to discuss the economic outlook and the related considerations with which the Congress must grapple in the coming months. You face the unenviable tasks of judging how effective various policies might be in improving the disappointing outlook for the economy, and of weighing the benefits of such measures against their possible longer-term costs.

Unfortunately, as I will discuss today, stimulative fiscal policies now face unusual handicaps that will make it difficult for the Congress to brighten the economic outlook for the immediate future.

THE ECONOMIC OUTLOOK

As every American knows, the economic outlook is disturbing. The slight expansion in real gross domestic product shown in the data for the second and third quarters signaled to economists that the recession was over, at least for now. But the recovery has turned out to be far weaker than most forecasters -including the Congressional Budget Office (CBO)--had predicted. During the past two or three months, little or no growth in employment or real personal incomes has been visible, and initial claims for unemployment benefits remain disturbingly high. Retail sales, new orders for durable goods, housing starts, and other indicators that gauge the strength of overall demand

have been pallid, as have such monthly indicators of the strength of output as industrial production.

CBO is still in the process of developing its new economic forecast. Our views, however, do not differ markedly from the consensus among economists. The consensus forecast sees the economy growing very slowly if at all over the next six months or so. It predicts only a slight growth in the number of jobs during the first few months of the new year, and a rise in unemployment. Such tepid growth is expected to continue until the lower interest rates of recent months begin to stimulate a stronger expansion in spending, and that spending begins to translate more clearly into added employment and personal income.

This forecast of little or no growth over the next several months is uncertain and could prove to be optimistic. Many economists are quite worried that even the flat performance could deteriorate further and confront the nation with a renewed recession early next year. Such a prospect appeared quite unlikely only a few months ago. If the current weakness does turn into a "double-dip" recession, production and incomes could slide for a few months, and unemployment could rise disturbingly before a sustained recovery begins.

With or without a double-dip **recession,** most forecasters suggest that the economy will finally begin recovering in earnest sometime around the middle of next year. Even then, virtually no one predicts a growth rate anywhere near what has been typical early in past recoveries. Whereas growth in the average postwar recovery has averaged above 6 percent during the four quarters immediately following the recession's low point, most forecasters are expecting an expansion at roughly half that rate during 1992. As a result, unemployment is projected to decline lethargically and the rate of unemployment is likely to stay above 6.5 percent through most of 1992.

For the longer **term,** most current projections show the rate of growth settling down toward a sustainable or **"potential"** level of 2.3 percent or less. This rate is lower than that achieved over the postwar period, in large part because growth in the labor force has declined and because low national saving reduced the growth of productive capital during the 1980s.

WHY THE WEAK RECOVERY?

Although monetary policy is now trying to push the economy toward recovery, an unusual coincidence of structural problems has made it difficult for the economy to mount a decisive recovery and is apt to keep the expansion well

below customary rates once recovery is actually under way. Some of these problems were present before the recession but have been exacerbated by the downturn; others have developed more recently and are not strongly tied to the recession.

The Federal Reserve's monetary policy helped bring on the recession, but more recently it has shifted to a stimulative stance. The attempts of the central bank to slow economic growth from the strong pace of the late 1980s, combined with the contractionary effects of last year's crisis in the Persian Gulf, originally pushed the economy into a recession. Even before the recession started, however, the Federal Reserve turned its policy around and began reducing interest rates. As a result, the yield on three-month Treasury bills has fallen by more than four percentage points since its peak in March 1989, and now stands at its lowest level in 14 years. Partly in response to declining short-term rates, yields on longer-term securities are also down, though less markedly. The rate on 10-year Treasury bonds has dropped by more than one and one-half percentage points from its peak in late 1990, and is now at its lowest level in more than four years.

In part because some measures of the money supply have continued to grow slowly, economists are divided over whether the monetary stimulation that the Federal Reserve has provided thus far is enough, With inflation

under control and other factors impeding the recovery, most believe that additional easing measures could only help the economy.

One group of longer-term factors that is hindering recovery involves the aftermath of the boom in spending for real estate and the strong expansion of bank lending for that and other purposes during the 1980s. Those developments left the nation with a glut of commercial buildings and, by extension, with a chronic weakness in new construction. Related to the legacy of the 1980s' real estate boom is the current effort among banks and other financial institutions to build capital and improve the quality of their portfolios by being more selective in making new loans. But although tight lending practices may help to shore up financial institutions, by reducing the availability of funds to some borrowers, especially in the Northeast, they may also be impeding the recovery.

Federal fiscal policies are also working to slow the recovery. The federal government has not eased overall fiscal policy significantly, as it did during previous recoveries. As a result of its long-term effort to reduce the budget deficit--an effort that is embodied in the spending limits in the Budget Enforcement Act of 1990--the Congress has adopted few expansionary federal budget initiatives this year, giving federal fiscal policy a more restrictive stance than has been true in most previous recoveries, These budget cuts were set

in motion in order to reduce the amounts by which chronic large deficits are limiting the nation's prospects for longer-term economic growth. While such cuts should brighten long-term economic prospects, they promise to make economic expansion more sluggish in the short term.

Similar restrictive pressures are also apparent in the budget tightening policies of state and local governments. Under pressure from shortfalls in revenue brought on by the current downturn, state and local governments have raised taxes and cut spending by at least $15 billion since the beginning of the fiscal year last July. Further, such cutbacks are continuing.

Economic difficulties in other countries are also slowing the U.S. recovery. Canada, our largest trading partner, is struggling to rebound from a recession of its own, and its economic vital signs remain unstable. Monetary policy has been slowing growth in Japan, and recent declines in the Tokyo stock market have dampened the pace of expansion there. Germany's attempts to control inflationary pressures and shore up the deutsche mark in the aftermath of unification have helped raise interest rates everywhere. The effects have been especially acute in other countries within the European Monetary System, which have had to raise their own interest rates to keep their currencies within fixed bands relative to the mark. Obviously, the

economic slowdowns that have resulted in those countries have helped limit the market for our exports.

A final group of problems is sapping the strength of the **recovery--** namely, the pressures that American businesses face to cut their costs and increase their competitiveness. These pressures **stem,** in **part,** from competition from abroad, and, in **part,** from changes in the structure of the U.S. economy. Analysts point to the shrinking of the defense industry, under way for some years now, as one of the structural convulsions the economy must endure. Many economists expect similar shrinkage in other sectors, such as retailing and finance, where significant excess capacity appears to exist. In these sectors and in the economy as a whole, the recession clearly has intensified pressures to cut costs and improve competitiveness. The result, of course, has been layoffs and other belt-tightening steps.

CAN POLICY HELP THE ECONOMY RECOVER?

With the economic outlook as troubled as it is, quite understandably the Congress is thinking of fiscal initiatives to stimulate a recovery and give a boost to a long-run economic expansion. Unfortunately, fiscal policies face

unusual handicaps that will make it difficult to jump start the economy quickly.

Several factors will constrict the effectiveness of any fiscal measure in stimulating the economy quickly without compromising other policy goals. First, of course, is the simple fact that all stimulative policies act with a lag. It will take time for the Congress and the Administration to agree on new measures, for changes to be carried out, and for the economy to react fully to them. All of this means that policy will not be able to soothe economic hardships significantly during the next several months.

Ironically, the nature of some policies that have been proposed for stimulating the economy have posed other difficulties. For example, many current proposals entail little overall fiscal stimulus because they do not increase the deficit significantly. In an effort to satisfy the constraints of the Budget Enforcement Act of 1990 and avoid compromising the longer-term goal of reducing the deficit, many current proposals cut taxes for some group or sector of the economy but offset the effects on the deficit through increases in taxes on others or selective cutbacks in spending. As a result of the offsetting cutbacks, the short-term stimulative impacts of such proposals are likely to be much diminished, and could even turn out to be counter-productive.

Still another constraint on the effectiveness of some current proposals to spark the economy is that certain of their provisions, designed to address longer-term economic problems, undercut the main purpose of stimulating extra spending now. For example, saving incentives such as personal income tax provisions to expand eligibility for Individual Retirement Accounts are meant to further longer-term economic growth by encouraging households to save higher proportions of their incomes. If they are effective, these provisions would reduce overall demand in the near term. Economic recovery, however, depends on doing exactly the reverse: inducing consumers and others to spend more money to help put people back to work. If provisions to encourage saving are included in current economic expansion packages, they will undermine their effectiveness in boosting the economy and lowering unemployment in the short run.

Another reason for which the short-run effectiveness of some stimulative fiscal measures may be limited is the risk that they might cause an unusually precipitous rise in interest rates. Any effort to stimulate expansion by increasing overall demand is apt to raise interest rates somewhat. Such increases normally reduce the effectiveness of the fiscal measure in stimulating the economy, but they do not eliminate it.

Now, however, there is the possibility that interest rates may rise more sharply than usual as the Congress considers budgetary measures to stimulate the economy. This hike in rates could occur if financial markets interpret the measures as signaling the end of the **hard-won,** long-term progress in deficit control that was made through the Budget Enforcement and Omnibus Budget Reconciliation Acts only last year. If interest rates were to rise especially sharply because of such fears, they could reduce or even eliminate whatever stimulating effect the budgetary measures might have.

Finally, certain current proposals for stimulus could compromise the nation's long-term economic goals because they would undermine the effects of recent reforms that were intended to make the tax code more neutral in order to promote the long-term productivity of the economy. The 1986 Tax Reform Act made great progress toward these goals by lowering marginal tax rates for both individuals and corporations and eliminating or scaling back a wide array of tax preferences.

Reducing marginal tax rates dampened incentives for people to convert income to nontaxable forms and to evade tax. Removing tax preferences encouraged people to select investments based on their true economic productivity instead of special tax advantages. By raising marginal rates for some taxpayers or granting preferential treatment to some forms of income

or types of **investment,** some current proposals could turn back the clock in these respects.

WHAT POLICIES MIGHT BE MOST EFFECTIVE?

The factors that I have just discussed indicate that fiscal policy measures cannot be expected to brighten the economic picture quickly and may well compromise other economic goals to some degree. Nevertheless, some may regard the prolonged period of relatively weak economic **activity** that faces the nation as reason enough to enact stimulative policies now.

Quick passage of legislation to stimulate the economy could reduce the possibility of a prolonged period of economic stagnation next year. Although most forecasters expect a more solid economic recovery to begin by midyear, their expectations could prove to be optimistic. There is a risk that the large number of structural problems that face the economy could keep the recovery from beginning in earnest for a longer period than most forecasters now believe. If so, fiscal measures that are enacted this winter could help overcome prolonged economic inertia and get the recovery going. In effect, enacting a stimulative fiscal policy early could provide insurance against unexpectedly slow growth later next year.

Even if the recovery does begin roughly when economists are now predicting, it is likely to be slow enough that the delayed effects of stimulative fiscal measures would bolster its strength. The slow recovery that is predicted for next year will prove unsatisfactory to many: unemployment is apt to fall only slowly, and conditions are likely to remain difficult in some regions and sectors of the economy. If the stimulative effects from fiscal policies enacted in the next few months are felt late in the year, they might well help push a reluctant recovery along.

For much the same **reason,** the risk that enacting fiscal measures now may overstimulate the economy seems slight. Economists typically argue against stimulative policies during the low point of an economic downturn for fear that the effects will not be felt until the economy is growing strongly on its own accord, as has been typical during postwar recoveries. If delayed stimulative effects are felt during such a period of strong economic growth, they are apt to add to inflationary pressures, and to provide the impetus for restrictive monetary policies as a result. In the current **environment,** however, the economy is unlikely to grow strongly enough to make renewed inflation much of a risk. As a result, the potential short-term costs of fiscal actions now are less than usual.

What Fiscal Measures **Would** Work Best?

If stimulative fiscal policies are adopted, it will be important to design them in such a way as to maximize their short-run effectiveness and minimize the damage they do to the nation's long-run economic goals. The previous discussion of the limits of some of the current proposals suggests several criteria.

First, the Congress should recognize that little short-term economic stimulation is possible without increasing the budget deficit. Therefore, if effective short-run stimulus is desired, it will be necessary to depart from the strict limits of the Budget Enforcement Act in designing new measures.

Second, in order to avoid pushing up interest rates and thereby undermining the stimulus, the measures should clearly be temporary and not lead to permanent increases in the deficit. If permanent changes are made in the tax code, any revenue losses should be offset in the future in ways that are credible and binding.

Of course, the stipulation that measures must increase the deficit only temporarily may limit their effectiveness in stimulating the recovery. Economists recognize that temporary reductions in individual income taxes,

or permanent reductions in those taxes that are offset after a few years by cutbacks in other programs, may lead only to feeble increases in private spending. Consumers are likely to react cautiously because they anticipate the higher taxes or the cutbacks in income as a result of other restrictive fiscal measures that they would face in the future. Still, temporary measures would have the virtue of avoiding boosting interest rates sharply by permanently increasing the deficit.

Third, it would be most useful for policymakers to act swiftly. Fiscal measures take time to affect the economy, and a prolonged debate leading up to enactment will only delay these impacts further.

Finally, the most useful measures would be those that, once enacted, provide most of their stimulative effect quickly, rather than spreading it over a period of many months or years.

Among the measures that come closest to satisfying these criteria are rebates on 1991 tax liabilities, temporary increases in grants to state and local governments, and temporary investment tax credits. Permanent tax cuts that were offset by delayed reductions in spending or tax increases in later years would also come close to meeting the requirements.

Rebates on 1991 tax liabilities have the clear advantage of being one mechanism for injecting a substantial amount of purchasing power into the economy quickly. In **addition,** rebates are temporary and do not permanently alter the structure of the tax code. Their major drawback is that they may give rise to little new spending: economic research suggests that consumers are likely to save much of any rebates they get.

Temporary increases in grants to states and local governments could be effective, but only if the recipient governments put them to use quickly either to avoid planned cutbacks in services or to delay tax increases. However, those states and localities that do not have to make further adjustments in their budgets in the next few months might save their added grants until their next fiscal year, delaying the stimulative impact. If the increased grants were restricted to investment projects, the effects would also be delayed because of the complexity in getting such activities started.

Investment tax credits stimulate business investment by lowering the cost of qualified capital to businesses and increasing corporate cash flow. Most econometric studies show, however, that lowering the cost of capital has little immediate effect on investment. Moreover, there is a risk of needlessly increasing the budget deficit by granting tax credits for investments that would have been undertaken anyway. But making the credit temporary and making

it apply only to increases in investment above some threshold amount could make it act swiftly and be more cost-effective. A temporary investment tax credit would have a much more powerful immediate effect on investment in the targeted time period than a permanent credit by encouraging firms to accelerate investments planned for future years. Limiting such a temporary credit to investments above a threshold amount determined, for example, by a firm's investment in recent years would reduce the budgetary cost per dollar of new investment.

CONCLUSION

The Congress and the Administration face a difficult set of decisions. The continuing weakness in the economy is causing serious hardships for millions of Americans, a situation that seems to cry out for action. At the same time, however, fiscal policies to stimulate the economy operate under special handicaps, and offer little hope for quick success. Moreover, any actions that are taken to respond to the economy's cyclical weakness are likely to compromise the nation's long-run economic goals to some degree.