An Assessment of the President's Proposal to
Stimulate the Economy and Create Jobs

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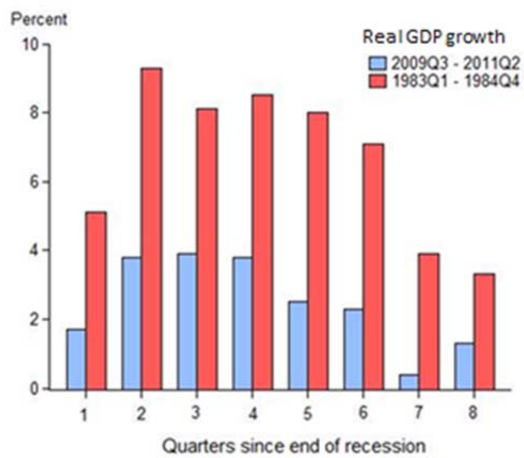
Chairman Jordon, Ranking Member Kucinich, and other members of the Committee, thank you for the opportunity to testify at this hearing on "Take Two: The President's Proposal to Stimulate the Economy and Create Jobs." After a deep recession and an anemic recovery, unemployment remains tragically high. Americans are understandably concerned about the future. They want an economic plan that works.

The main reason for the high unemployment rate is very weak economic growth. Firms are not starting up enough, or expanding enough, or hiring enough to bring the unemployment rate down. Real GDP growth has averaged only 2.4 percent per year in this recovery compared with 6.5 percent in the 1983-84 recovery from the most recent very deep U.S. recession. As a result, fewer people as a percentage of the working age population are working now than when the recovery began.



This graph tells the bleak story. The uniformly shorter bars show the quarterly growth rates of GDP during the eight quarters of this recovery in comparison with the eight quarters in 1983-84. Economic growth has not exceeded 4 percent for even one quarter in this recovery.

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The fiscal policy responses to the economic growth and employment problem have not been effective thus far. The policy has consisted mainly of short-term temporary and targeted interventions, which have not had a sustainable impact on economic growth. Instead, the policies have increased the federal debt and raised uncertainty, which is an impediment to economic growth. What is needed is a more permanent and comprehensive economic strategy.

Unfortunately, the proposals made by President Obama on September 8 consist largely of the same type of temporary and targeted interventions that have been tried for the past several years. This recent experience and past experiences show that this type of fiscal policy will not increase economic growth, certainly not on a sustained basis. It will not therefore bring the unemployment rate down to pre-recession levels which should now be the goal of policy. This is not to say, of course, that all the specific proposals made by President Obama are without merit. Indeed, some of the proposed reforms of the federal unemployment insurance program to remove the disincentives that actually raise unemployment are worth considering, as are the proposals to expedite regulatory approval and other permit decisions for high priority projects.

To understand why the package will not work to raise economic growth, one needs to go beyond the President's September 8th speech and look at the overall composition of the package as described in the fact sheet provided by the White House.[1] To be sure, the full package has not yet been released, so any assessment must be preliminary. Neither the legislation needed to implement the package nor the proposed budget changes in future years, which are supposed to offset the current size of the package, have been released.

In any case the total $447 billion budgetary size of the package can be divided into (1) temporary tax cuts and one-time payments and (2) grants for the purchases of goods, including infrastructure, and services by state and local governments and government agencies.

The temporary tax cuts and payments sum to $307 billion, or about 2/3 of the total package; these include a temporary one-year reduction in payroll taxes paid by employees ($175 billion) and employers ($65 billion), as well as a temporary new jobs tax credit, one more year of expensing, and an extension of unemployment insurance benefits.

The aim of the remaining $140 billion is to increase government purchases of goods and services.[2] Because legislation has not yet been submitted, it is not clear how much of the $140 billion would be in the form of grants to state and local governments versus direct spending by the federal government, but the nature of the targeted government purchases—local public schools, state and local government workers, rehabilitation of vacant property—means that most will likely be in the form of grants to state and local governments. For example, 60 percent of the funds for school reconstruction would go to "the 100 largest high-need public school districts" with states allocating the rest to other districts.

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[1] "Fact Sheet and Overview," Office of the Press Secretary, The White House, September 8, 2011

[2] A Returning Heroes Tax Credit of up to $5,600 for veterans unemployed six months or longer and a Wounded Warriors Tax Credit of up to $9,600 for veterans with service-connected disabilities unemployed six months or longer are presumably not temporary, but no estimates for these programs are included in the fact sheet.

In sum, the package is temporary and targeted, and it relies mainly on federal grants to state and local governments to increase the purchases of goods and services. In all these respects, the President's proposal of last week is quite similar to the 2009 stimulus package, the American Recovery and Reinvestment Act (ARRA). A large fraction of ARRA was in the form of temporary one-time payments to people or temporary refundable tax credits. As I testified to this Subcommittee last February, I examined where this ARRA money went in the aggregate and found that it did not boost aggregate consumption and thus job growth. People largely saved the money rather than spent it.

I found the same thing happened when one-time payments were made to people in 2001 and 2008. And, going back further, economists found roughly the same thing in the 1970s when such policies were enacted. An example is President Ford's temporary rebate of 1975, which his own Council of Economic Advisers found did not add to the recovery in any sustainable way, and thus concluded in January 1977 that "Tax reduction should be permanent rather than in the form of a temporary rebate." Yet another example is President Carter's 1977 temporary new jobs tax credit, which was later assessed as largely ineffective by economist Emil Sunley, who was at the U.S. Treasury when President Carter's program was implemented.

In marked contrast to these cases of temporary tax cuts, the permanent and comprehensive tax reductions implemented in the early 1980s were associated with the strong recovery of 1983-84 so evident in the graph above. And no such temporary interventions were enacted during the rest of the 1980s or 1990s, a time of generally good economic performance.

The other important similarity between the President's recent proposal and the 2009 stimulus relates to the aim of increasing infrastructure and other government spending. Under ARRA, the federal government borrowed money and gave it to the states in the hope that they would start new construction projects and hire people. But the data indicate that the state and local governments put most of grant money in their coffers. These governments started few construction projects that they would not have started without the stimulus. The federal government also undertook its own construction programs as part of the stimulus; but, as is apparently true of the recent proposal, they were very small in total. As with the temporary tax rebates, there is also evidence from the Carter Administration that these types of public works policies are not a sustainable way to get the economy growing. For example, economist Ned Gramlich found that the grants to the states in the Carter administration were not effective for much the same reason I give here in reference to the 2009 stimulus.

It is important to note that the recent and historical evidence that temporary and targeted fiscal interventions do not increase economic growth is nonpartisan. Ineffective temporary and targeted policies were enacted in both Republican and Democratic Administrations and Congresses. That some Republicans or some Democrats proposed or voted for such packages, as is frequently mentioned, does not of course prove that they work.

Some argue that the economy would have been even weaker without the 2009 stimulus, but the only evidence they site are simulations of models which provide no new information. The actual money flows reveal little or no effect.

Even supporters of such programs admit this problem with the President's recent proposal. For example, in assessing the proposal as laid out in the September 8 speech and the fact sheet, the consulting firm Macroeconomic Advisers reported that "the GDP and employment effects are expected to be temporary" and more specifically that "these proposals will pull forward increases in GDP and employment, not permanently raise their level."

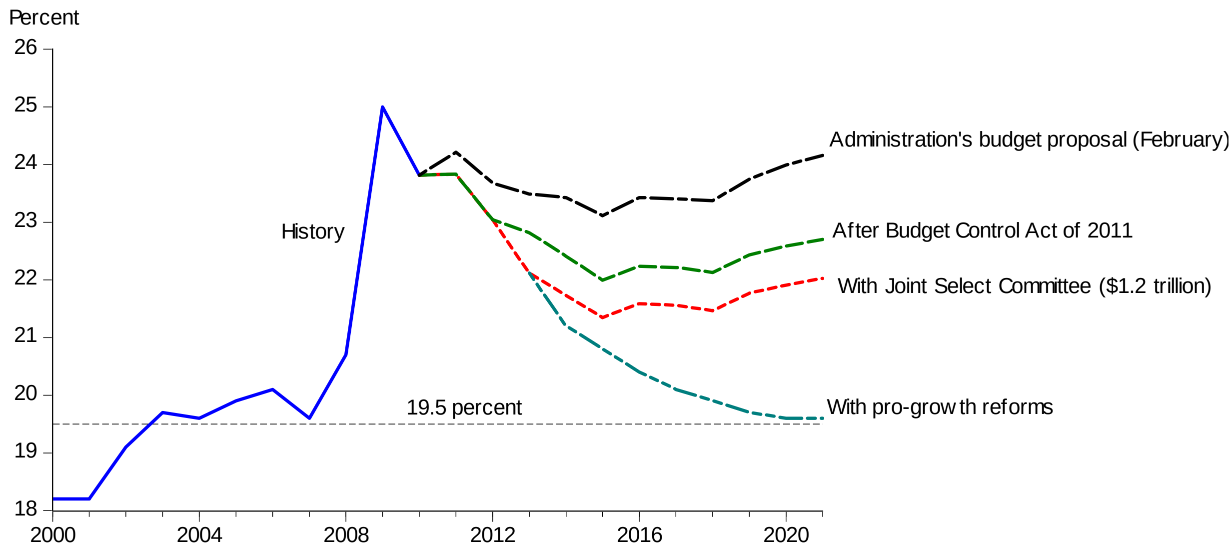
If the Administration's proposal will not work then what will?

In my estimation, the temporary and targeted fiscal policy interventions in the 2009 stimulus package and most others—cash-for-clunkers, first-time homebuyers credit, and the sharp increase in federal outlays from 19.6 percent in 2007 to 23.8 percent of GDP today—have not only been ineffective, they have lowered investment and consumption demand by increasing concerns about the federal debt, another financial crisis, threats of inflation or deflation, higher taxes, or simply more interventions. Most businesses have plenty of cash to invest and create jobs. They're sitting on it because of these concerns. Thus the impact of this policy uncertainty and unpredictability shows up as a lack of demand.

So the best thing government can do to create sustained consumption and investment demand is to move away from such temporary actions and start now on a clear comprehensive strategy going forward. Part of the strategy should be to lay out a plan to reduce the deficit and the growth of debt gradually and credibly over time, and thereby remove some of the concerns and fears, whether about another financial crisis or inflation or deflation or tax increases. Other reforms should accompany such a budget strategy, including permanent pro-growth tax reform and regulatory reform, which will help stimulate the economy in a more sustained way. This is the most promising way to get a good recovery going and reduce unemployment.

I can illustrate one such comprehensive budget strategy with the following graph, which shows federal outlays as a percent of GDP from 2000 to 2021. Federal spending has risen sharply as a percentage of GDP in recent years which suggests the feasibility of bringing it down again as a share of GDP.

The top line in the graph shows the path of outlays in the original February budget submission of the Administration, as scored by CBO. The line labeled "After the Budget Control Act of 2011" is simply the new CBO baseline estimated in August. It thus incorporates the Budget Control Act as well as other changes since the CBO scored the Administration's budget, including the 2011 Continuing Resolution. The line labeled "With Joint Select Committee" shows the additional spending reductions as a share of GDP that will occur if the Joint Select Committee reduces outlays by $1.2 trillion over 10 years, with the year-by-year distribution of outlays over those years based on CBO assumptions in "Budget and Economic Outlook: An Update," of August 2011.



Federal Outlays as a Percent of GDP

Clearly the Budget Control Act has substantially changed the budget picture since the start of this year, but there is still a long way to go.

The line in the graph labeled "With pro-growth reforms" illustrates a comprehensive budget strategy. Nothing changes relative to the Budget Control Act until 2014 when outlays as a share of GDP start moving down further until they gradually reach the 2007 percentage level which should be enough to balance the budget without tax increases, or better yet with a fully revenue-neutral pro-growth tax reform.

While the Select Joint Committee might expand its mandate to consider such reforms, the obvious differences of opinion may have to be hammered out in the 2012 election with all Americans participating. Tax reform, as well as entitlement reform, regulatory reform, monetary reform—indeed the fundamental role of government in the economy—should be part of that debate, which should have as its overall goal increasing economic growth and substantially reducing unemployment on as sustained basis.