ADDRESSING SHORT- AND LONG-TERM FISCAL CHALLENGES

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Mr. Chairman, Senator Gregg, and other members of the Committee, thank you for the opportunity to testify.

The Short Run

There is no doubt that these are perilous times. We economists generally rely on historical data to help understand the present and predict the future, but since World War II, there has not been a historical precedent for what we are experiencing. There has not been the same breakdown in credit markets and the same astounding policy response. The Federal Reserve System has been increasing bank reserves at an explosive rate, and we are considering a fiscal stimulus program many times the size of any ever contemplated.

Because we are in uncharted waters, it is necessary to be somewhat modest in providing policy advice. The prevalent theme in recent discussions is that the risk that we shall do too little exceeds the risk that we shall do too much. But I believe that there is a need for dissenters, and we

[1] I am not representing nor speaking on behalf of any organization. I am a salaried employee of the Urban Institute. The observations and suggestions I present should be identified as my own and not necessarily those of the Urban Institute, its officers, or its Board of Trustees.

must ask how much of too much can we tolerate. The risks of overdoing it are severe and are not emphasized enough in the current discussion.

I have several concerns regarding the proposed stimulus package:

1. The combination of highly expansionary monetary and fiscal policies may lead to an excessive boom.
2. The speed with which the national debt is being increased could eventually cause a very rapid rise in interest rates on Treasuries, or in a worst-case scenario create another bout of instability in international financial markets.
3. The federal, state, and local bureaucracies may not have the capacity to efficiently manage the huge increase in spending that is being contemplated.
4. A significant portion of the spending increases and tax cuts in the package will become permanent and significantly worsen the very serious long-run budget outlook.

Risk of an Excessive Boom—One hears many dire economic forecasts these days, but considerable weight should be given to the recent forecast of the Congressional Budget Office. It tends to reflect the consensus forecast, but it makes no allowance for the beneficial effects of a stimulus package. Nevertheless, the CBO expects the recovery to start later this year and be well underway in 2010.

The spending associated with the stimulus will play out over two years and, because of time lags, the bulk of the expansionary impact will come after the trough implied by the CBO forecast. The infrastructure spending will be especially slow to get going. The description of the House plan refers to $64 billion of highway projects that can be started within 180 days, and the bill would presumably finance $30 billion of that amount. It is worth emphasizing that 180 days is almost six months. Presumably, one can accelerate the timing somewhat, but then one must finance less worthy projects. Even tax cuts take about six months to have their full effect on spending according to recent estimates.

Consequently, if the CBO forecast is correct, it is best to think of the stimulus, not as something that will much limit the rise in unemployment, but rather as something that will hasten the recovery. If the huge monetary stimulus starts to have an impact at the same time, we could see a runaway boom that the Federal Reserve would have to stop in its tracks.

It is worth thinking back to the stock market crash of 1987. In response, the Fed poured liquidity into the system, although not remotely as much as they have recently. Economic growth accelerated in 1988, inflation became a problem in 1989, and the Fed had to tighten to the point of causing the recession of 1990–91. Given that the policy response this time is much more dramatic, the resulting cycle could be much more violent.

If, on the other hand, CBO is being too optimistic about the state of the economy, that should be evident in a few months. Ideally, we would have a much smaller stimulus package today, but a supplement ready to go if things turn out worse than expected.

Increase in the National Debt—Recently, the CBO projected deficits of $1.2 trillion and $0.7 trillion in 2010. But these estimates do not include any stimulus program, any relief from the alternative minimum tax, extension of other temporary tax cuts, necessary war spending, or increases in other appropriations. It is reasonable to expect a deficit approximating $1.5 trillion in 2009 and something well over $1 trillion in 2010. The debt in the hands of the public is likely to rise from about 40 percent of GDP to 60 percent by the end of 2010. Relative to GDP, the increase in the debt in 2009 alone will be twice the previous record set in 1983, when President Reagan was accused of running irresponsible deficits. The increase over two years will be about 50 percent. That is to say, we shall be asking private and government investors around the world to increase their holdings of U.S. government securities by 50 percent in two years.

Currently, the appetite for U.S. debt seems virtually unlimited with the interest rate on 90 day Treasury bills almost zero. But the important question is, "What interest rate increase will be necessary to induce people to continue hold Treasuries once their desire for more risky securities returns to normal?" If the unusually high spread between corporate bond and Treasury interest rates starts to decline, the recovery will be slowed if the risk premium shrinks because Treasury rates rise instead of corporate rates falling. The situation will be even worse if a Treasury auction of debt fails, much as a German auction failed within recent days. We could see a recurrence of financial instability, and that would be devastating to the economic recovery.

Whatever the probability of such unfortunate outcomes, there is one thing that we know with certainty. The interest bill on the debt will soar in future years and probably become a serious budget problem in its own right.

The Management Capacity of the Federal, State and Local Bureaucracy— The stimulus plan proposed in the House would enormously increase the budgets of certain agencies and for particular activities in the state and local sector. To put the plan into perspective, total federal spending on physical investment has been running at about $120 billion, the bulk of which is in the form of grants to state and local government. Highway spending has been less than $40 billion. How much of the money in the House bill should be classified as physical investment is uncertain, but it appears as though the annual budget would be increased by at least $140 billion over two years, that is, almost a 60 percent increase. It looks like the federal budget for highways would increase more than a third. I do not hear of plans to increase the size of the federal bureaucracy temporarily by comparable amounts, and one wonders whether the existing civil service can provide adequate oversight. Lesser percentage increases are implied for state and local investment budgets, but there are major areas in which the civil service could experience severe strains when asked to spend so much money in such a short time.

There are huge increases for scientific research of various types when it is hard to argue that scientists are among those hardest hit by unemployment. In fact, one wonders if there are enough extra scientists to do the work.

More generally, the budget increases are so large that there is bound to be much waste and some outright fraud. There is some risk that we shall experience a Katrina rescue-type fiasco. I suspect that the money would be better spent if more were allocated to the safety net—unemployment insurance, food stamps, and SSI.

Temporary versus Permanent Spending—A relatively small proportion of the tax cuts and spending increases provide by the stimulus bill is intended to be permanent. It could be argued that none should be. However, the greater danger is that spending that is intended to be temporary will turn out to be permanent. Just as there will be huge increases in particular budgets at the state and local level, there will be have to be huge cuts after two years. State and local revenues hopefully will grow enough in the recovery to supplant the temporary federal assistance, but that assistance is supposed to come to an abrupt end, whereas the restoration of state and local revenues will occur gradually. There are bound to be severe mismatches, and where the cessation of federal aid requires drastic cuts in budgets, it will take considerable political courage to end the so-called temporary program.

Conclusion—Although I feel that it would be much preferable to have a much smaller stimulus package with extra tranches waiting in the wings if needed, that is probably a quixotic wish at this point. However, there is much talk of Congress expanding whatever package the administration puts forward and I see that as being extremely risky. It would be far preferable and may enhance confidence in bond markets if Congress were to trim the administration package to some degree. To the degree that Congress alters the composition of the package, it would help to enhance tax cuts somewhat and reduce the reliance on infrastructure investments. Tax cuts may not get quite as much bang for the buck, but they will have an effect much more quickly. Infrastructure investments will be much slower to get going and to complete. A significant portion is also very likely to be wasteful. On the spending side, increases in the generosity of safety net benefits are both likely to have considerable bang for the buck and to work quickly.

The Long Run

The budget problems the nation will face in the long run are well known. Social Security, Medicare, and Medicaid constitute almost 50 percent of noninterest spending, and all three programs are growing faster than tax revenues. The growth rate will accelerate as the baby boom retires. At the same time, our tax system is inequitable and terribly inefficient economically. It is hard to imagine using it to collect significantly more revenue without substantial reforms.

The huge increase in the debt that we shall experience in the short run makes the task of reforming the budget both more difficult and more urgent. However, our short-run problems also present a golden opportunity. Short-run difficulties often make people more willing to accept long-run reforms. Sweden, Canada, Germany, and Japan have all undertaken fundamental reforms in their Social Security systems in response to short-run crises.

Nevertheless, entitlement and tax reform are excruciatingly difficult politically. It will take a departure from normal procedures to make any progress. Therefore, Chairman and Senator Gregg are to be congratulated for suggesting a bipartisan commission that would make proposals that would then be considered as a package and voted up or down. I think that it is appropriate that the commission should consist of elected officials and a few high-level officials from the administration. Technicians have presented hundreds of policy options. Only elected officials and other high-level policymakers can bargain their way to an acceptable compromise.

I believe that the only competing process that might have a chance of success is a bipartisan summit, such as the one that fashioned an enormously important budget deal in 1990. (The summit recently suggested by the president-elect seems to be quite different from the 1990 summit in that it would include a number of experts as full participants.) A summit can be thought of as an expansion of the Conrad-Gregg commission, and the 1990 summit did provide a policy package for an up or down vote. Alas, they failed on their first try and had to go back and refashion the package before they could attract majority support.

I believe that a summit has a few advantages over a commission. It can have broader representation and its rules of procedure may not have to be as rigid. It can also do its work in private. The imposition of an up or down vote by a commission might be too much for Congress to swallow, and there may be less flexibility to try again if the first try fails. On the other hand, the openness and transparency of a commission may make their conclusions more acceptable to the public.

It may be useful to have a commission that tackles the budget problem sequentially. Although soaring health costs present the most serious budget problem by far, it may well be advantageous to tackle Social Security reform first. Possible reform options are well known and we know a good deal about their effects. The same cannot be said about the prominent options for reforming Medicare and Medicaid. If a bipartisan reform of Social Security could be fashioned, the two parties might develop the trust necessary to take on the much more difficult challenges of health and tax policy reform.