Testimony of

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Thank you, Mr. Chairman. I am pleased to appear before this committee to discuss the important issue of a fiscal stimulus – whether it is needed and, if so, what form it should take.

(1). <u>The U. S. economy is now very weak and could get substantially weaker.</u>

There is likely to be little or no increase in real GDP in the current quarter. Virtually every economic indicator – including credit conditions, housing, and employment – has deteriorated during the past month.

I believe that the probability of a recession in 2008 now exceeds 50 percent. If it occurs, it could be deeper and longer than the recessions of the recent past.

(2) <u>A recession is, however, not inevitable.</u>

There are several reasons to believe that a recesssion in 2008 can be avoided.

First, although housing construction is in free fall, the large role played by services like health care makes the economy less cyclically volatile than it was in the past.

Second, since the Federal Reserve only began reducing rates in August, the full impact of easier money has not yet been felt.

Third, the lower dollar has made US products more competitive in the global economy, raising exports by 25 percent in the past two years. Additional dollar declines in 2008 can add further stimulus.

Further easing by the Fed and a fiscal package passed by the Congress would reduce the risk of recession and dampen any downturn that does occur.

Most private forecasters are still projecting that the economy will slow but not actually decline in 2008.

(3) But the risks of a serious downturn that feeds on itself are large enough to warrant strong countercyclical monetary policy.

The Federal Reserve should reduce the fed funds rate by at least 50 basis points at its meeting next week* and should continue cutting that rate toward three percent in 2008 unless there is a clear sign of an economic improvement or of significantly deteriorating inflation.

> The CPI is up more than 4 percent over the last 12 months and has been rising at a 5.6 percent rate over the past three months. Even without food and energy, the core CPI is up 2.4 percent over the past 12 months and at a 2.7 percent rate for the past three months.

Because of current credit market conditions, there is a risk that interest rate cuts will not be as effective in stimulating the economy as they were in the past.. That is why a fiscal stimulus deserves attention.

But even with the credit market problems, lower interest rates can still help by lowering monthly payments on adjustable rate mortgages, decreasing the cost of borrowed funds, and making the dollar more competitive.

(4) The lower interest rate should be supplemented by enacting a temporary tax cut and a temporary increase in transfer payments. While it would be best if this package is triggered to take effect only if there are further signs of economic downturn, an immediate fiscal stimulus would be better than doing nothing

When I testified to the House Budget Committee on December 5th, I suggested that Congress enact a major tax cut that would be triggered to take effect if the economy deteriorates substantially. I proposed a three month decline in payroll employment as the triggering event.

Enacting such a conditional stimulus would have two desirable effects. First, it would immediately boost the confidence of households and businesses since they would know that a significant slowdown would be met immediately by a substantial fiscal stimulus.

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*This testimony was written on January 20th, before the recent Federal Reserve 75 basis point reduction. In light of the financial market turmoil of the past few days, I believe that an additional rate reduction next week is warranted.

Second, if there is a decline of employment (and therefore of output and incomes), a fiscal stimulus would begin without the usual delays of the legislative process. In effect, such a pre-enacted conditional fiscal stimulus would be an automatic stabilizer in the same way that the payout of unemployment benefits is now.

Although the sustained decline in employment that I favor as a trigger for the fiscal stimulus has not occurred and may never occur, economic conditions have generally deteriorated since early December:

- the unemployment rate is up and private employment has declined;
- real average weekly earnings are down,
- disposable personal income has fallen
- house prices and household wealth have fallen
- retail sales have declined
- housing starts are down 38% from December 2006 and 14 % in just the last month.
- industrial production has slowed and capacity utilization is down
- the Institute of Supply Management survey shows manufacturing declining with contracting new orders, production and employment
- the leading indicators are down for the 3rd straight month

On balance, I still favor a "conditional" triggered package of tax cuts and transfer payments – that is, enacting the plan as soon as possible but triggering it to occur only when there is clearer evidence of a sustained economic downturn. Another possibility would be to start a portion of the stimulus package now with a further amount subject to an automatic trigger.

But I recognize that Congress may be reluctant to enact such a novel package and that triggering is not currently a part of the proposals of either the Administration or the Congressional Republicans and Democrats.

If the choice is between an immediate fiscal package or no fiscal stimulus, I believe that the continued deterioration has been enough to make an immediate fiscal stimulus better than doing nothing at this time.

(5) The fiscal package should be designed to stimulate economic activity and not to achieve other policy goals.

Its purpose is to increase household and business spending in order to raise total GDP. It should not be taken as an occasion to rebuild infrastructure, to reduce poverty, or to strengthen economic incentives. It should not be taken as an occasion to redistribute the burden of taxes.

That leads me to favor a flat tax rebate to all who paid taxes plus an increased cash transfer to low income groups who are not taxpayers. This could be done by increasing federal government payments for food stamps, TANF (Temporary Assistance of Needy Families) and Supplemental Security Income. The key is to use those transfer payments that can be achieved quickly.

While lower income households may eventually spend a higher portion of their tax rebates, those with higher incomes may respond to the legislation more rapidly, using credit cards or available savings to spend their tax rebates even before they receive the cash.

The total size of the package should be large enough so that the amounts received by each household cause a change in spending behavior. A $50 rebate is easily ignored while a $500 rebate is not.

This suggests a total package of $100 billion to $150 billion as a one-time stimulus. The net budget cost of the package would actually be less because these tax cuts and transfers would raise GDP and the higher GDP would produce additional personal and corporate tax revenue. As a rough guide, the net budget cost would be about 25 percent lower than the initial size of the package.

(6) Some other dos and don’ts of designing the stimulus package

Some form of investment incentive should be part of the current legislation because firms respond quickly to such legislation, placing orders even before the tax breaks take effect. In addition, investment incentives stimulate different types of spending than increased cash to households . The “bonus depreciation” provisions that Congress enacted earlier in this decade were helpful in stimulating the economy, just as various investment tax credits have been in the past.

While raising unemployment benefits or extending the duration of benefits beyond 26 weeks would help some individuals who might otherwise face financial hardship, it would also create undesirable incentives for individuals to delay returning to work. That would lower earnings and total spending. I think food stamps and SSI payments and TANF are therefore a preferred form of increased transfer.

Transfers to state and local governments would be a slow and complex process. So too would federal spending on infrastructure. These would weaken the effectiveness of any size stimulus package. .

The rule requiring that the cost of tax cuts and increased outlays be offset by increases in other taxes or cuts in federal spending should be waived in this context. It would clearly make no sense to do so concurrently since that would undermine the stimulative effect. Trying to reach legislative agreement on the content of a delayed offset would almost certainly prevent enacting any stimulus package. .

Thank you for your attention. I look forward to your questions.

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