

The Fiscal State of the Union

Testimony before the
Committee on the Budget
U.S. House of Representatives

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Thank you Chairman Jodey Arrington, Ranking Member Brendan Boyle, and other members of the Committee on the Budget at the U.S. House of Representatives for inviting me to testify on the topic “The Fiscal State of the Union.” This is a very important topic today, and I am pleased to offer my assessment. I have testified many times in the past fifteen years before both the House Budget Committee and the Senate Budget Committee, as some of the references listed at the end of this testimony show, and I will draw on some of those conclusions in my testimony today.

The State of the Federal Budget

I will begin with two tables in which I draw from the recently submitted Budget of the U.S. Government, Fiscal Year 2024.

Table 1 show the growth rate of real GDP from 2021 through 2031 in both year over year and 4th quarter to 4th quarter percentages. Note that rebound from the pandemic is clear in 2021. However, there is very little growth after that for the next ten years by either measure. The average of about 2 percent per year is due to policy, much related to fiscal policy.

Table 1. Growth Rate of Real Gross Domestic Product (Real GDP)

	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>	<u>2028</u>	<u>2029</u>	<u>2030</u>	<u>2031</u>
% change, year/year	5.9	1.8	0.6	1.5	2.3	2.1	2.0	2.0	2.1	2.2	2.2
% change, Q4/Q4	5.7	0.2	0.4	2.1	2.4	2.0	2.0	2.0	2.1	2.2	2.2

Source: Table S-9 Economic Assumptions, Budget of the U.S. Government for Fiscal Year

Table 2 shows the total budget for the same period, both in billions of dollars and as a percent of GDP. Note that outlays and receipts continue to grow as does the deficit in billions of dollars. Also as a percent of GDP, receipts, outlays, and the deficit remain high.

Receipts and outlays show virtually no decline. In this sense the fiscal state of the union is not good. Efforts now need to focus on reducing these budget totals with the ultimate aim of a balanced budget.

Table 2. Budget Totals in Billions of Dollars and Percent of GDP

Year	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>	<u>2028</u>	<u>2029</u>	<u>2030</u>	<u>2031</u>
Receipts	4,897	4,802	5,036	5,419	5,773	6,080	6,400	6,669	6,953	7,264
Outlays	6,273	6,372	6,883	7,091	7,294	7,589	8,003	8,205	8,639	9,040
Deficit	1,376	1,569	1,846	1,671	1,521	1,509	1,604	1,536	1,686	1,776

Budget totals as a percent of GDP:

Receipts	19.6%	18.2%	18.5%	19.1%	19.5%	19.7%	19.9%	19.9%	19.9%	19.9%
Outlays	25.1%	24.2%	25.3%	24.9%	24.6%	24.6%	24.9%	24.5%	24.7%	24.8%
Deficit	5.5%	6.0%	6.8%	5.9%	5.1%	4.9%	5.0%	4.6%	4.8%	4.9%

Source: Table S-1, Budget Totals, Budget of the U.S. Government for Fiscal Year 2024

At previous hearings at the House Committee on the Budget at which I testified, including 2015 hearing entitled “Why Congress Must Balance the Budget,” I showed that basic economic theory and empirical models imply that high federal government debt has a cost: it reduces real GDP and real income per household compared to what these would be with lower debt levels. A reexamination of the economic costs conducted yields the same results. Hence, there is a need for a fiscal consolidation strategy in which spending grows at a slower rate than GDP for a while, thereby reducing spending as a percentage of GDP

Model simulations show that the impact on real GDP would be positive in both the short run and the long run. Real GDP increases throughout the model simulation, with the benefits rising over time. Even in the short-run, the consolidation of government finances is found to boost economic activity in the private sector sufficiently to overcome the reduction in government spending. Consumption and output increase at the start with further increases later on. Investment rises by only a little in the short run, but by more in the longer run.

The economic rationale for these positive results is straightforward: With a gradually phased-in and credible budget plan, households can take into account future reductions in government spending and higher expected future incomes. Businesses will also be able to adjust. Given a reduction in tax rates in later years, especially compared with likely tax increases, they would also face more favorable conditions for production, investment and work effort. Of course to reap all these positive benefits, it is essential that the tax and budget plan be credible.

Is there another policy response which would have worked better or would work better in the future? In testimony entitled “The State of the Economy and Principles for Fiscal Stimulus” which I gave before this Senate Committee in November 2008, I recommended a different type of fiscal policy.

The response was based on certain established economic principles, which I summarized by saying that policy should be *predictable, permanent and pervasive* affecting incentives throughout the economy. I argued “that there are many good fiscal packages that are consistent with these three principles. One would consist of the following”: (1) Committing to keep income tax rates where they are, effectively making current income tax rates permanent. (2) Making the tax credits permanent rather than temporary. (3) Enacting responsible government spending plans that met reasonable long-term objectives, put the U.S. economy on a credible path to budget balance, and would be expedited to the degree possible without causing waste and inefficiency. (4) Recognizing that the “automatic stabilizers” will help stabilize the economy, and therefore counting them as part of the overall fiscal package even though they do not require legislation.

This is not the kind of economic policy that has been proposed going forward. Rather than predictable, the policy response has created uncertainty about the debt, growing federal spending, future tax rate increases, new regulations, and the exit from rules-based monetary policy. Rather than permanent, it is temporary and thereby has not created a lasting economic recovery. And rather than being pervasive, it targets certain sectors or groups. It is not surprising, therefore, that the policy has left us with lower growth.

The good news is that we can get back to a strong recovery by following an economic policy based on fundamental economic principles. As argued in a *Wall Street Journal* article “A Better Strategy for Faster Growth,” published by George Shultz, Gary Becker, Michael Boskin, John Cogan, Allan Meltzer and me, the recent experience and plans for the next few years makes the case for doing so stronger than ever

Guidelines for Economic Policy: Permanent, Pervasive, and Predictable

The mantra often heard during the debates about stimulus proposals is that it should be temporary, targeted, and timely. (See Elmendorf and Furman (2008), for example). Going forward, we need a renewed set of principles and a new mantra. Based on recent and many past experiences as well as much economic theory, I recommend this alternative stimulus mantra: permanent, pervasive, and predictable.

Permanent. The most obvious lesson learned from the stimulus program of this year is that one should have strong misgivings about a temporary stimulus program. Such a program is not likely to have much impact, and any impact it has will be short lived. Temporary is not a principle we want to follow if we want to get the economy moving again. Rather we should be looking for more lasting or permanent fiscal changes. More lasting or permanent tax changes will be more effective in helping to turn the economy around in a lasting. We need to worry about the next few years, not just the next few months.

Pervasive. One of the arguments in favor of “targeting” the stimulus package is that by focusing on people who were “liquidity constrained” the bang for the buck would be larger. But such targeting does not keep the stimulus from being ineffective. Moreover, targeting implies that letting tax rates increase. But increasing tax rates on businesses or on investments, especially in the current economy, would increase unemployment and further weaken the economy. Better

to seek an across the board approach where both employers and employees benefit. When people are losing their jobs and their life savings, the last thing they want government to do is increase tax rates on the firms who hire them or on the asset markets where their money is invested.

Predictable. While timeliness is an admirable attribute, it is only one temporal property that a good fiscal policy should have in a large dynamic economy. Even more important is that policy actions be clear and understandable—that is predictable—so that individuals and firms know what to expect as they make decisions which depend on future government actions. One of the most widely heard complaints about government interventions is that they have been too erratic or even ad hoc. In my view financial markets are clamoring for clarity. Economic policy—from monetary policy, to regulatory policy, to international policy, to fiscal policy—works best if it is as predictable as possible.

Conclusion

I believe that there are many good fiscal packages that are consistent with these three general principles, and would put the U.S. economy on the road to an improved fiscal state and thereby faster and more inclusive economic growth. I conclude with one fiscal package that is an example of what is needed. It would consist of the following:

(1) A commitment, passed into law, to keep income tax rates were they are now, effectively making current income tax rates permanent. This would be a significant stimulus to the economy and to the financial markets because tax rate increases are now expected on small business income, capital gains income, and dividend income. Committing to keep marginal tax rates from increasing will boost the economy right now. This commitment on tax rates could be reinforced with a pledge not to alter current international trade agreements, which would give additional stimulus to the economy.

(2) Responsible government spending plans that meet reasonable long-term objectives, put the U.S. economy on a credible path to budget balance, and are expedited to the degree possible without causing waste and inefficiency.

(3) An explicit recognition that the “automatic stabilizers” are likely to help stabilize the economy, and should be viewed as part of the overall fiscal package even though they may not require legislation.

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