



## Testimony

# Strengthening Our Fiscal Toolkit: Policy Options to Improve Economic Resiliency

DOUGLAS HOLTZ-EAKIN | OCTOBER 16, 2019

Testimony to the U.S. House Committee on the Budget

*\*The views expressed here are my own and do not represent the position of the American Action Forum. I am indebted to my colleague Gordon Gray for many valuable conversations.*

Chairman Yarmuth, Ranking Member Womack, and Members of the Committee thank you for the privilege of appearing today to discuss the important issue of economic resiliency. In this short testimony I hope to convey three main points:

- The U.S. economy already displays considerable resiliency; despite significant headwinds there is no imminent recession and growth continues at a solid pace.
- The best way to improve economic resiliency is to fortify the long-run, trend rate of economic growth. Negative shocks are an economic fact of life; the faster the economy is growing the less like that it falls into negative territory.
- While the logic of automatic stabilizers is impeccable, there are good reasons to be cautious about a dramatic expansion of federal mandatory spending and reasons to be skeptical about the political economy of their effectiveness.

Let me discuss these in turn.

### **The Near-Term Economic Outlook**

The near-term outlook is for solid but slowing growth; and far from an imminent recession. Measured as growth from the same quarter one year ago, growth in real gross domestic product (GDP) accelerated steadily from its recent low of 1.3 percent in the 2<sup>nd</sup> quarter of 2016 to 3.2 percent in the 2<sup>nd</sup> quarter of 2018. Since that time, growth has slowed appreciably reaching 2.3 percent in the 2<sup>nd</sup> quarter of this year. Moreover, both the Atlanta Fed's GDPNow and the New York Fed's Nowcast estimate of 3rd quarter growth rate translates to year-over-year growth of 2.0 percent.

Importantly, personal consumption expenditures (PCE, or household spending) is 70 percent of economic activity and it has remained rock solid. From the 2<sup>nd</sup> quarter 2016 to the 2<sup>nd</sup> quarter 2018, it averaged year-over-year growth of 2.7 percent. Over the more recent period it has averaged 2.9 percent. That is a rock-solid foundation for GDP growth that is slower, but a long way from negative territory.

One often gets a much more negative picture of the state of the economy. One source of this is the commentary regarding the monthly Bureau of Labor Statistics (BLS) release of the employment report. Most of the attention

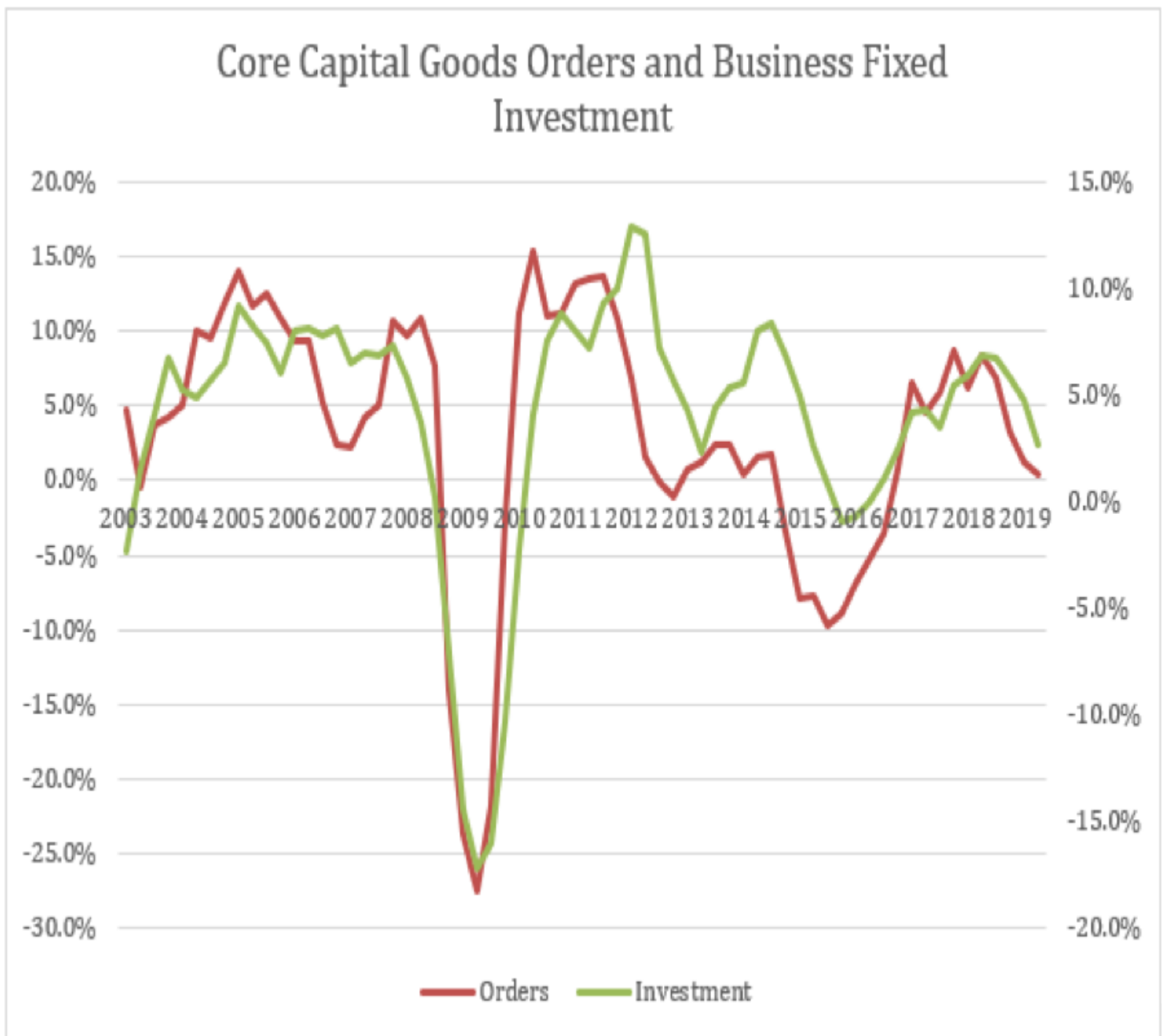
is typically focused on the unemployment rate (currently a very low 3.5 percent) and the number of new jobs created. Unfortunately, these figures present a very narrow — and potentially misleading — snapshot of economic health. As the expansion has continued, the capacity of the economy to draw new workers into the labor force and out of unemployment become steadily more limited. As a result, the potential for “new jobs” gets steadily more limited as well. It is not a sign of any failure that the average number of new jobs has fallen from 223,000 per month in 2018 to 161,000 thus far in 2019. (Note: These data have not been adjusted for the so-called benchmark revision. The BLS has already signaled that the total jobs in the economy will be revised down by about a half-million, but the pattern is what matters.)

A more significant piece of data is the growth of average hourly earnings — especially for production and non-supervisory workers (i.e. blue-collar labor). The year-over-year growth has moved up from 2.3 percent in 2017 to averaging 3.4 percent thus far this year. Strong wage growth is a reflection of the restoration of productivity growth in the U.S. economy (productivity was up at an annual rate of [2.3 percent in the 2nd quarter](#)). It is also the foundation of growth in incomes; labor income is jobs times average hours times wages, and average hours worked have not fluctuated significantly.

Similarly, there is an excessive focus on manufacturing. The news that the [ISM Manufacturing Index](#) fell into contraction territory has fed recession fears. But there are over 151 million employees in the United States, and under 13 million are in manufacturing. Put differently, for every worker in manufacturing there are nearly 11 more elsewhere in the economy.

In addition to manufacturing, there are other weak parts of the economic outlook: housing, farming, and trade. Housing has struggled for the duration of the Trump Administration. The farm economy was in bad shape and the retaliation to Trump’s trade policies have turned bad to dreadful. Trade flows are down sharply in direct response to the tariffs and the generalized decline in global trade.

Perhaps the most important issue for the outlook is the future path of business fixed investment (BFI). In particular, the decline in BFI is the mirror image of the ramp-up that occurred from 2016 to the fall of 2018, which drove the topline growth rate above 3 percent. As shown below, orders for non-defense capital goods excluding transportation are a good barometer of the business-investment environment. The data displayed are the growth rates from the same quarter one year earlier for orders (red line, left axis) and BFI (green line, right axis). The sharp upswing in both to roughly 7 percent in the fall of 2018 was the heart of the Trump-era boom; the subsequent decline to close to zero year-over-year growth is the source of the current weakness.



### Improving Resiliency and Reducing the Probability of Recession

The single most important objective should be to raise the long-term trend rate of economic growth. This has direct implications for the pace at which standards of living increase, but also reduce the probability of a recession.

The reality is that negative shocks are part of economic life, whether they are natural disasters, commodity price shocks, droughts, global financial pressures or any of a myriad of other economic headwinds that arise. If the economy is growing slowly, say 1.0 to 1.5 percent, these shocks raise the specter of an actual downturn. The concomitant reductions in consumer and business confidence may snowball into a recession. If the economy is growing more rapidly, say 2.5 to 3.0 percent, a recession is far less likely.

Are there ways to achieve this objective? Yes. While the U.S. faces a slowdown stemming from the demographic shift, pro-growth policies that augment the core rate of productivity can generate a higher trend growth rate.

### Trade Policy

Trade is an important driver of productivity and economic growth in the United States and globally. Trade creates jobs, increases GDP, and opens markets to American producers and consumers.

The current trade policy outlook is challenging. The United States is the most robust trading partner in the world, with combined trade volume in 2017 of goods and services valued at over \$5.2 trillion. Among nations, the United States was the second-largest exporter of goods and the largest exporter of commercial services as of 2017. Trade is vital to the United States, the largest economy in the world, and the trade policy landscape is unsettled.

Congress has an opportunity to contribute to improving the trade outlook by considering the United States-Mexico-Canada Agreement (USMCA). The USMCA modernizes the existing North American Free Trade Agreement (NAFTA) by adding protections for intellectual property and updating rules on digital trade. The agreement also updates prevailing trade rules related to the agriculture, manufacturing, and automotive industries. While the economic implications for the USMCA should not be overstated, demonstrating the capacity to ratify trade agreements would send a meaningful signal to global trading partners and remove some policy uncertainty from the economic horizon.

### Tax Reform

Prior to the enactment of the TCJA, the U.S. tax code was broadly viewed as broken and in need of repair, and for good reason. A sound reform of the U.S. tax code was an essential element of a pro-growth strategy, and this reform promises to support substantially increased long run economic growth.<sup>[1]</sup>

The TCJA addressed some of the most glaring flaws in the business tax code. It lowered the corporation income tax rate to a more globally competitive 21 percent, enhanced incentives to investment in equipment, addressed some of the disparate tax treatment between debt and equity, and refashioned the nation's international tax regime. Primarily for these reasons, the TCJA will enhance the nation's growth prospects.

The TCJA was an important first step in improving the U.S. tax code but should not be viewed as the final word in U.S. tax reform. Several features of the bill will need to be revisited and improved. Specifically, the temporary provisions should be made permanent. These include business and individual provisions, and expensing of qualified equipment should top the list of provisions that should be made permanent.

Making these changes permanent, however, should be done in a revenue neutral way. According to the President's Budget, just making the individual and estate tax provisions of the TCJA permanent would cost \$541.6 billion over the next decade.<sup>[2]</sup> It would be fiscally imprudent to layer this additional deficit effect on top of existing budget challenges.

Congress should also continue the *reform* effort of tax reform and continue to flatten distortions in the tax code. The tax preference for debt over equity, for instance, persists in the tax code and should be revisited.

## Continued Regulatory Reform

Perhaps the most striking policy departure from the previous administration has been in the area of regulatory reform. The Obama Administration finalized a costly regulation at the average rate of 1.1 per day, and the cost of complying with those regulations cumulated to \$890 billion – according to the agencies themselves that issued the regulations. That cost is an average stealth tax increase of over \$110 billion a year.

Enter the Trump Administration which, by executive order, imposed regulatory budgets on the agencies. If the rules finalized by the agency-imposed costs greater than the allotted budget, the agency had to find offsetting reductions by eliminating other regulations. This approach was popularized as the “one in, two out” approach to regulations. How did it work out? From his inauguration to the end of fiscal 2017, the total burden rose by only \$5 billion — a far cry of the \$1000+ billion annual burdens for the 8 years prior. Fiscal 2018 was even more dramatic, with the regulatory burden actually falling by \$6 billion.

As [detailed](#) by Dan Bosch and Dan Goldbeck the Trump Administration established a goal of \$17.9 billion in total savings (across all executive agencies) for its regulatory budget. Although the final results are not yet fully in, Bosch and Goldbeck project that the administration will miss its target, but still cut the regulatory budget by \$8.6 billion in fiscal 2019.

While this constitutes remarkable progress in halting the growth of the regulatory state it could easily be reversed under another administration. There remains a need for structural regulatory reform to check the growth of the regulatory state in the future. For example, the Regulatory Accountability Act (RAA) is one example of how Congress can impose structural checks on future burdensome regulations. Among other provisions, the Act defines a “high-impact” rule as a measure that would impose annual costs of \$1 billion and require an advanced notice of proposed rulemaking for any high-impact rule. It would also require a public hearing before adoption and for agencies to adopt rules on the basis of the best evidence and the least cost to the economy. This is one of several potential legislative efforts that could improve checks on regulatory growth.

## Immigration Reform

Immigration reform can raise both population and labor force growth, and thus can raise GDP growth. In addition, immigrants inject entrepreneurialism into the U.S. economy.<sup>[3]</sup> New entrepreneurial vigor embodied in new capital and consumer goods promises a higher standard of living. Without this policy effort, low U.S. birth rates will result in a decline in the population and overall economy. An economically based immigration reform would raise the pace of economic growth substantially, raise GDP per capita, and reduce the cumulative federal deficit.

## Entitlement Reform and a Sustainable Debt Trajectory

One of the biggest policy problems facing the United States is that spending rises above any reasonable metric of taxation for the indefinite future. A mini-industry is devoted to producing alternative numerical estimates of this mismatch, but the diagnosis of the basic problem is not complicated. The diagnosis leads as well to the prescription for action. Over the long-term, the budget problem is primarily a spending problem and correcting it requires reductions in the growth of the largest mandatory spending programs – namely, Social Security and federal health programs.

At present, Social Security is running a cash-flow deficit, increasing the overall shortfall. There are even larger

deficits and future growth in outlays associated with Medicare, Medicaid, and the Affordable Care Act (ACA). These health programs share the demographic pressures that drive Social Security but also include the inexorable increase in health care spending per person in the United States.

For this reason, an immediate reform and improvement in the outlook for entitlement spending would send a valuable signal to credit markets and improve the economic outlook. Alternatively, businesses, entrepreneurs and investors perceive the future deficits as an implicit promise of higher taxes, higher interest rates, or both. For any employer contemplating locating in the United States or expanding existing facilities and payrolls, rudimentary business planning reveals this to be an extremely risky environment.

But purely budget-driven arguments are insufficient to marshal support for entitlement reform. The large entitlement programs need reform in their own right. Social Security is a good example. Under current law, retirees will face a 23-percent across-the-board cut in benefits in less than two decades.<sup>[4]</sup> That is a disgraceful way to run a pension system. It is possible to reform Social Security to be less costly overall and financially sustainable over the long term.

Similar insights apply to Medicare and Medicaid, the key health safety nets for the elderly and poor. These programs have relentless appetites for taxpayer dollars yet do not consistently deliver quality outcomes. Reforms can address their open-ended draws on the federal Treasury and improve their functioning at the same time.

Growth-oriented fiscal strategy will re-orient spending priorities away from dysfunctional autopilot spending programs and toward core functions of government. It will focus less on the dollars going into programs and more on the quality of the outcomes. Such a strategy will do so because it is the principled approach, because it coincides with the best strategy to deal with the debt and growth dilemmas, and because it will force a restructuring of the entitlement programs to generate a quality social safety net.

In short, entitlement reform is a pro-growth policy move at this juncture. As summarized by AAF, research indicates that the best strategy both to grow the economy and to eliminate deficits is to keep taxes low and reduce public employee costs and transfer payments.<sup>[5]</sup>

## **Automatic Stabilizers**

Automatic stabilizers are provisions in law that generate greater aggregate demand as the economy slows or declines. For example, a progressive tax system acts as an automatic stabilizer because as incomes fall households move into lower tax brackets and have a greater fraction of their earnings available to spend. Similarly, the unemployment insurance (UI) system serves as an automatic stabilizer by providing income to the unemployed.

Obviously, the U.S. already has in place automatic stabilizers. There has been interest, evidenced by this hearing, in augmenting the system of automatic stabilizers. For example, in a recent Wall Street Journal opinion piece former Council of Economic Advisers Chairman Jason Furman argued<sup>[6]</sup>: “Congress should pass a law immediately that would automatically trigger stimulus if the labor market deteriorates, with unemployment rising rapidly. The package should include not only tax cuts but also relief for states, as well as extra help for people most hurt by recessions. The legislation should be permanent, the measures lasting as long as needed in the next downturn and set to trigger in future ones as well.”

At an abstract level, the argument is appealing. But I have reservations about the idea at this juncture. First, the U.S. already has automatic stabilizers (as noted above) and there has been no compelling case made that they are somehow insufficient. Indeed, “how big” is a difficult question to answer. It is far from obvious (to me at least) how to appropriately scale the kinds of provisions that are suggested.

The alternative to automatic stabilizers is discretionary actions by Congress in the event of a downturn. Congress can (and has) cut taxes, enhanced unemployment insurance, provided assistance to states, augmented the Supplemental Nutrition Assistance Program (SNAP), and so on.

Thinking about the alternatives raises two additional concerns. First, from a budgetary perspective, automatic stabilizers are mandatory spending, while discretionary policy is (literally) discretionary spending. Other things being equal, it would be unwise to create additional mandatory spending programs – mandatory spending is the long-run budget problem.

The second additional concern is that it seems most likely that the outcome will be both automatic and discretionary responses. I consider it extremely unlikely that faced with a significant downturn Congress and the administration will choose to do nothing and explain to the American people that their predecessors had taken care of this problem. Instead, regardless of the robustness of the automatic stabilizers that are in place, Congress and the administration will enact further discretionary policies. The result will be budgetary excess and unsound fiscal policy.

Thank you and I look forward to your questions.

#### Notes

[1] <http://americanactionforum.org/research/economic-and-budgetary-consequences-of-pro-growth-tax-modernization>

[2] <https://www.whitehouse.gov/wp-content/uploads/2018/02/spec-fy2019.pdf>

[3] Holtz-Eakin, “Immigration Reform, Economic Growth, and the Fiscal Challenge.”

[4] <https://www.americanactionforum.org/research/future-americas-entitlements-need-know-medicare-social-security-trustees-reports/>

[5] <http://americanactionforum.org/insights/repairing-a-fiscal-hole-how-and-why-spending-cuts-trump-tax-increases>

[6] <https://www.wsj.com/articles/launch-a-pre-emptive-strike-against-recession-11567723004>