Why a Credible Budget Strategy Will
Reduce Unemployment and Increase Economic Growth

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Chairman Casey, Vice Chairman Brady and other members of the Committee, thank you very much for the opportunity to testify at this hearing on "Spend Less, Owe Less, and Grow the Economy."

Fiscal Policy and the Weak Recovery

Though the recession officially ended two years ago this month, the unemployment rate is still unacceptably high at over 9 percent. The main reason for the high unemployment is that the recovery has been very weak, and it has been weak from the start, not just during this year. For example, Figure 1 compares GDP growth during this recovery with the recovery after the 1981-1982 recession. Economic growth in this recovery has averaged only 2.8 percent, compared with 7.0 percent in the comparable period in the 1980s. In my view government policies in the fiscal, monetary, and regulatory areas are responsible for this weak recovery.

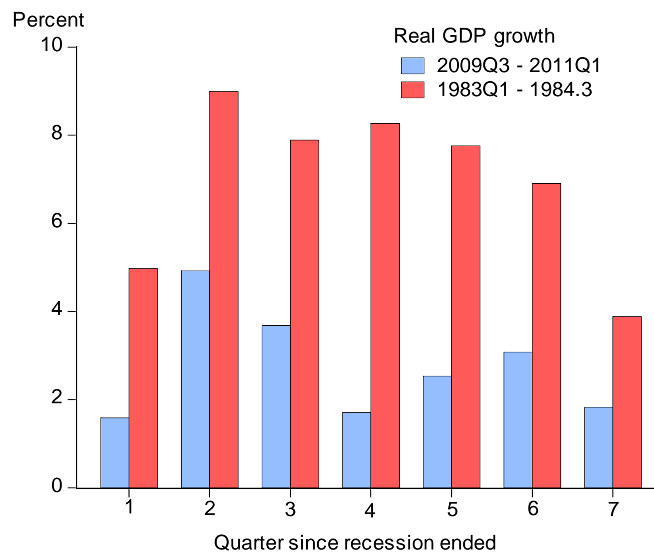

Figure 1 A Comparison of Two Recoveries

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In the area of fiscal policy we have seen an $862 billion stimulus package and a surge in federal spending from 19.7 percent of GDP in 2007 to over 24 percent now. These interventions had little or no effect in stimulating the economy or reducing unemployment. The stimulus payments to people did not jump-start consumption. The stimulus payments to the states did not increase infrastructure spending. The cash for clunkers program merely shifted consumption a few months forward. At the same time the deficit and the debt have exploded raising the risks of higher inflation, higher tax rates, higher interest rates and a major fiscal crisis—all impediments to private investment and job creation.

The highest priority now is to end the high growth of spending and the large deficits, and thereby return to sound fiscal policy with a balanced budget and without an increase in taxes. This will remove the risks, which are holding back private investment and job creation. We do not need another Keynesian fiscal stimulus package; we need a transition to a sounder fiscal foundation that promotes private investment and creates jobs.

Figure 2 illustrates how increases in private investment are associated with reductions in unemployment. In 2006, investment—business fixed investment plus residential investment—as a share of GDP was 17% and unemployment was 5%. By 2010 private investment as a share of GDP had fallen to 12% and unemployment went up to more than 9%. These ups and downs in unemployment and investment are due both to supply and demand factors, and they are part of a regular correlation going back for many decades, and they exist in other countries.

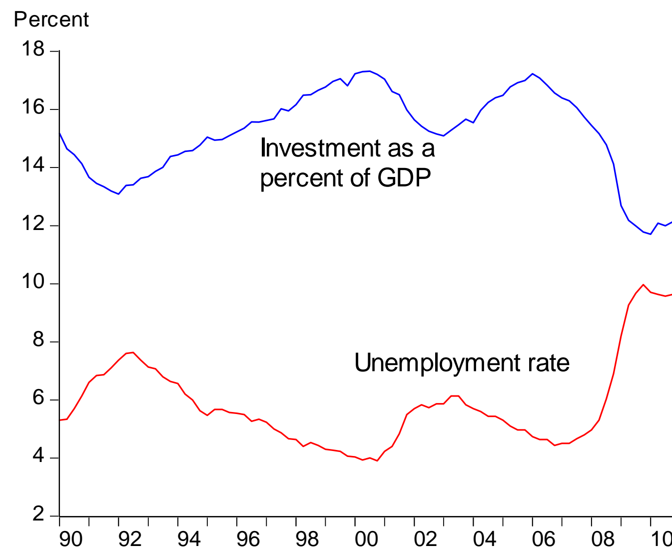

Figure 2 The Unemployment Rate in the United States
and Total Fixed Investment as Percent of GDP
From 1990Q1 To 2011Q1

In contrast, Figure 3 shows that higher federal government purchases of goods and services as a share of GDP are not associated with decreases in unemployment. Federal purchases are the part of federal expenditures that are a component of GDP; they do not include

transfer payments and interest payments. When government purchases of goods and services came down as a share of GDP in the 1990s, unemployment did not rise. And the increase in government purchases as a share of GDP since 2000 was not associated with lower unemployment. To the extent that government spending crowds out job-creating private investment, it can actually worsen unemployment.

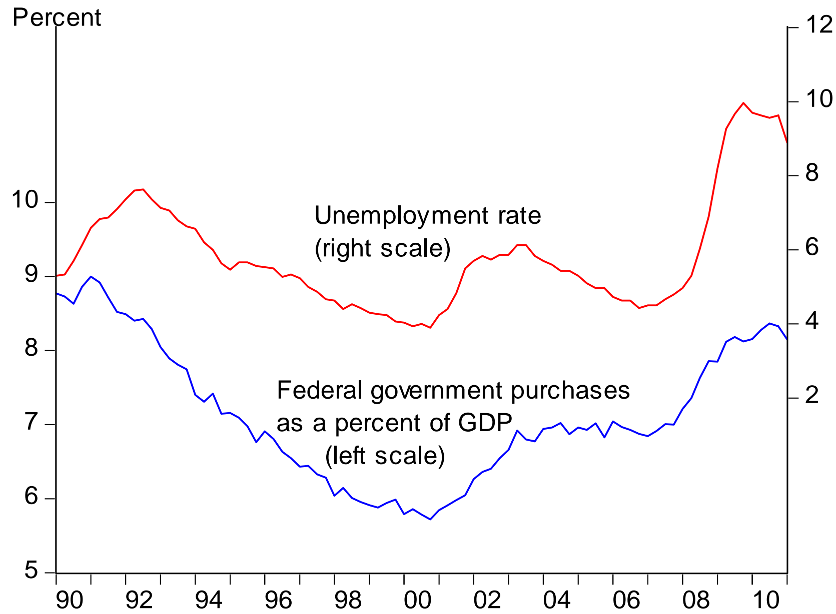

Figure 3 The Unemployment Rate in the United States and Federal Government Purchases of Goods and Services as a Percent of GDP From 1990Q1 to 2011Q1

A Credible Strategy to Restore Sound Fiscal Policy

The best way to reap the benefits of a return to a sound fiscal policy is with a credible and transparent budget strategy. Having a strategy is important because it enables the private sector to know what to expect in the years ahead and allows businesses to bolster their hiring and investing accordingly. Credibility is important because it helps alleviate people's concerns about higher future taxes or higher debt; if people are not confident that the government will follow through on promises to reduce spending in the future, then they will remain reluctant to move ahead. Economic simulations with forward-looking econometric models demonstrate the importance of credibility in budget consolidation plans.

What should such a credible budget strategy consist of? First, it should include a game-changer to demonstrate credibility; the most effective game changer would an agreement to remove the spending bulge of the past few years before it gets entrenched in government

agencies, preferably with a down-payment in the 2012 fiscal year. The strategy should also lay out a longer term path for spending which gradually brings government outlays into equality with the amount of tax revenues generated by the current tax system; the expectation that tax rates will not increase will be an immediate stimulus. The strategy should include instructions to appropriations subcommittees that will turn the spending goals into legislation as well as reforms of entitlement programs. And the strategy should include an enforceable budget rule to keep spending as a share of GDP moving along on the path stipulated in the strategy and incorporated in the legislation.

To illustrate these points, consider Figure 4 which shows outlays as a share of GDP under several budget scenarios. The top line shows the budget submitted by the Administration in February. The graph indicates that it does not have the characteristics outlined above; it does not bring spending down as a share of GDP at all, let alone to levels needed to balance the budget without tax increases, though more recent proposals from the Administration do apparently have more reductions as a share of GDP. The lower line shows the House Budget Resolution, which does have the characteristics of the strategy outlined above, at least under the assumption that taxes will settle in the 19 percent of GDP range under current tax rates.

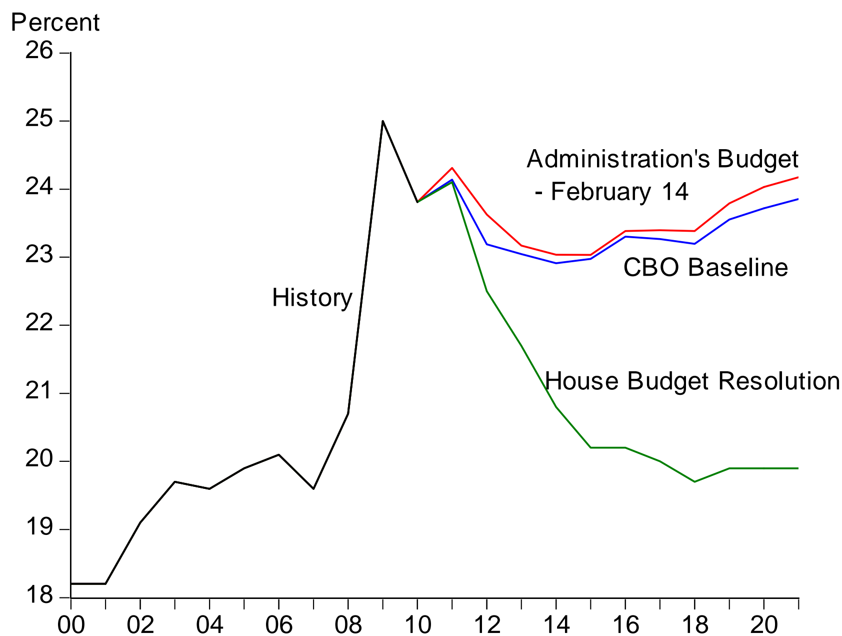

Figure 4 Federal Government Outlays as a Percent of GDP

Explaining the basic economics behind the strategy to people is essential. In my view, the strategy should be accompanied by a detailed yet simple economic explanation of why the strategy will increase economic growth and create jobs. The economic explanation should counteract claims that a strategy to restore sound fiscal policy will reduce growth or should be postponed because of the weak economy. For example, an economic explanation would show why most government agencies—such as Treasury and Commerce—can get by with the same amount of funding as a share of GDP that they had in 2007. It also should show that attempts to stimulate the economy with higher deficits and more government spending have not worked.

And it should emphasize that the strategy simply slows down the growth of total spending rather than actually cuts it.

For example, as shown in Figure 5, with the House Budget Resolution government outlays actually would grow at 2.8 percent per year over the ten years from 2012-2021 under the CBO projection that nominal GDP will grow at 4.6 percent per year. Faster GDP growth than 4.6 percent will bring a balanced budget more quickly by increasing the growth of tax revenues.

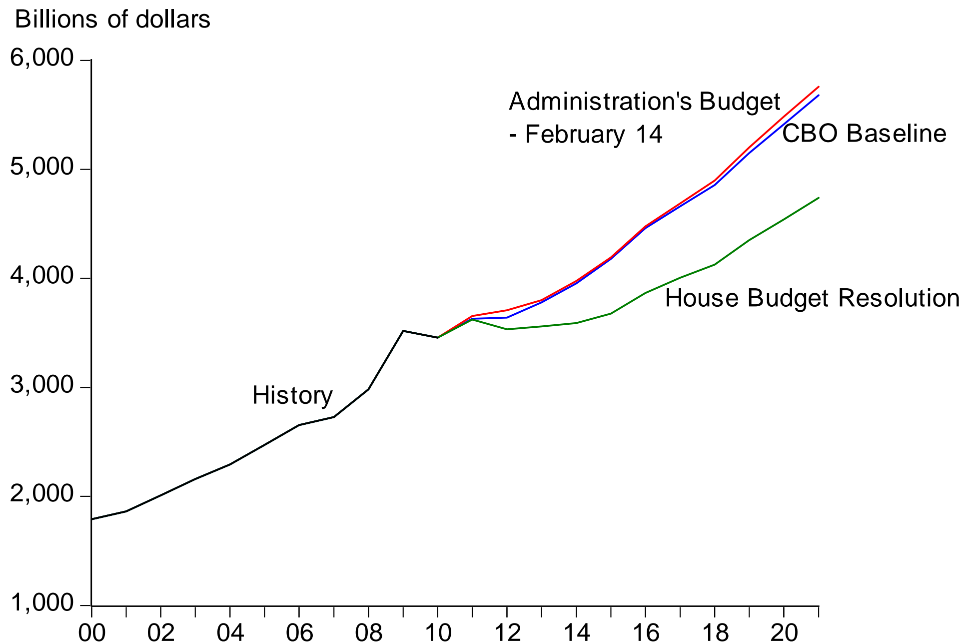

Figure 5 Federal Government Outlays

Finally, the economic explanation should emphasize that the budget strategy is one part of a larger pro-growth, pro-employment government-reform strategy which also includes monetary reform, tax reform and regulatory reform.

A Two Step Implementation

Figure 4 (or Figure 5) illustrates the difficulty of laying out a budget strategy in the current political environment. The gap between the upper and lower budget lines in Figure 4 represents huge differences of opinion on how much to reduce spending and deal with the deficit. The size of the gap between the upper and lower lines in Figure 4 is over $6 trillion. So how can one lay out a credible strategy in such a situation?

One suggestion which would preserve the idea of such a strategy in this environment would be to implement the strategy in two steps. Under step one, which would be part of the ongoing debt limit increase negotiation, there would be an agreement to reduce spending growth by about $2½ trillion over ten years, which is the amount of the debt increase needed to get through 2012. The path would be somewhere between the lines in Figure 4 or 5, but closer to the

top line. Nevertheless, linking the slowdown in spending growth to the debt limit increase, would increase credibility in the process, as would making sure that a material part of the spending growth reductions occur in 2012, not just in the out years.

Step two of the strategy would then wait until the outcome of the elections in November of next year, and would center on whether the remaining gap of about $3½ trillion would be filled by spending growth reductions, as I have argued for here, or by tax rate increases as others have argued. Though the entire outcome would still be uncertain, the degree of uncertainty would be reduced compared to the current situation.