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CONGRESSIONAL TESTIMONY

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Of

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My name is J.D. Foster. I am the Norman B. Ture Senior Fellow in the Economics of Fiscal Policy at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

At best, stimulus efforts based on government spending and tax cuts with little or no incentive effects have done no harm. At best. It is quite possible most of these efforts over the past couple of years have slowed the recovery while adding hundreds of billions of dollars to the national debt.

The record is all the more unfortunate because it is possible for a President and Congress to work together to stimulate the economy to faster growth during and after a recession. They can do so by improving incentives to produce and to work: for example, by reducing regulations and tax distortions. They can do so by reducing the uncertainties surrounding future policy. They can do so by expanding foreign markets for domestic goods and services. Recent efforts to stimulate the economy have been unsuccessful because they did little or none of these things. Regulations have increased. Uncertainty has increased. Tax distortions have been left in place or even increased in some areas. And efforts toward free trade have been anemic, at best.

Stimulus can work, but it has not worked because the Administration took another approach, emphasizing tax relief with little or no incentive effects combined with massive increases in spending. The President inherited a ballooning budget deficit and opted to grow it further. At best, this would be expected to be ineffectual. At best, because the resulting increased deficits infused economic decision-making with even more uncertainty about the consequences of massive deficit spending and how and when government will act to restore fiscal sanity.

Fortunately, the economy is showing clear signs of sustained recovery; uneven recovery to be sure, stronger in some areas than others both geographically and by industry, but recovery nonetheless. Despite the tremendous blows from the financial crisis and all that it entailed, the underlying strengths of our free market system once again are at work, giving expression to the vitality, energy, and innovation of the American people. Make no mistake: Our economy is recovering despite—not because of—the actions taken in Washington to grow it.

Signs of Taking the Wrong Road

The heart of the Administration's approach to stimulus is the equivalent of fiscal alchemy. Alchemy, "the art of transmuting metals," refers specifically to turning base metals like lead into gold. Fiscal alchemy is the attempt to turn government deficit spending—whenever, wherever, and on whatever—into jobs. Regarding near-term stimulus, it is not a matter of how wisely or foolishly the money is spent. It is not a matter of how quickly or slowly the money is spent. It is not a matter of whether some is saved or not—any more than the phase of the moon or adding a bit more wolfsbane or a

stronger electric current enhances the prospects for lead to become the substance of an alchemist's dreams.

The basic theory of demand-side stimulus is beguilingly simple. The theory observes that the economy is under performing and total demand is too low, and thus total supply needed to meet that demand is too low. It would appear obvious enough, then, that a solution is to increase demand by deficit spending and rising supply will naturally follow. The net of government spending over tax revenues adds to total demand. Increase the deficit and you increase demand, supply naturally follows, and voila: the economy is stronger and employment is up. One wonders then why government should not simply increase spending much, much more and create instant full employment.

Why, indeed. The answer, as is now obvious, is that this policy does not work for the simple reason that government must somehow fund this additional spending, and it does so by borrowing. Suppose you take a dollar from your right pocket and transfer it to your left pocket. Do you have a new dollar to spend? Of course not.

Or suppose you pour a bucket of water into a bathtub. You would expect the level of the water to rise. But where did the water in the bucket come from? It came from dipping it into the bathtub. You may make a splash, but when the water settles, in terms of the water level nothing will have changed.

An increase in government borrowing to finance an increase in deficit spending produces one of two ensuing events, either of which (or in combination) leaves total demand unchanged. First, the increase in government borrowing can mean a reduction in the amount of saving available for private consumption and private investment. Government demand goes up, private demand goes down, total demand is unchanged.

Alternatively, the increase in government borrowing may be financed not by reducing private borrowing but by an increase in net inflows of foreign saving—either a reduction in the gross outflows of U.S. saving or an increase in the gross inflows of foreign-sourced saving. Total demand remains unaffected, however, because the balance of payments still balances, and so the increase in net inflows of saving is matched by an increase in the net inflows of goods and services—the increase in the trade deficit offsets the increase in deficit spending.

Underlying this simple confusion surrounding demand-side stimulus is that the theory ignores the existence of a well-developed financial system, the job of which fundamentally is to direct private saving into private consumption, private investment, or government deficit spending. Even in the past few years, when the financial system has worked poorly in the sense that institutions have failed, markets struggled, and the direction of investment dollars has been less than stellar, the markets still managed to take every dollar of saving and direct it toward a borrower willing to take it *and use it*. Demand-side theory presumes the existence of financial markets, as government must rely on those markets to issue debt to finance deficit spending, but then ignores that

absent the additional government borrowing, markets would have directed the saving to other purposes, which would have added to total demand in the same amount.

These economic relationships are analogous to the law of conservation of energy, which says that energy can be neither created nor destroyed in a closed system, but can only be transformed from one state to another. If we exclude the possibility of cross-border capital flows, then the closed system is the domestic economy and the energy conserved is the amount of saving available. If we allow for the possibility of cross-border capital flows, then the closed system is the global economy and the energy conserved is the amount of domestic saving augmented or diminished by the second closed system of the balance of payments.

You Could Be a Demand-Sider If...

There are some tell-tale signs that one has intentionally or inadvertently fallen prey to demand-side stimulus alchemy. One such sign arises when one engages in discussions about multipliers. The multiplier principle is simple enough—if government deficit spending rises by a dollar, does total demand rise by more than a dollar? Make no mistake. One must first accept the possibility that government deficit spending can boost total demand before one embarks on an empirical investigation of multipliers. First, one must believe that lead can be turned into gold to investigate the advantages of incantations over potions.

Another tell-tale sign is references to whether amounts are saved or spent. For example, one argument in favor of direct spending over broad-based tax relief is that every dollar of spending is spent, whereas some portions of a tax cut are saved, and the higher the income of the tax cut recipient, the more from a tax cut is likely to be saved. A related example is the argument that the additional cash income from extending the Unemployment Insurance program for the long-term unemployed is highly likely to be spent virtually in toto, suggesting that such a policy is particularly efficacious stimulus.

Whether the monies resulting from deficit spending are saved or spent matters not a whit to the immediate level of economic activity. If these monies are spent, then private demand must fall by the amount borrowed. If the monies are saved, then government debt is higher and private saving is higher, yet total demand is again unmoved.

One of the original motivations for the demand-side theory of fiscal stimulus was the observation that private saving might be parked in unproductive locations. We hear echoes of this today when, for example, the President refers to the need for private companies to employ their enormous cash hoards to increase investment and employment.

For example, during the Great Depression many citizens took to stashing their saving around the house as faith in the security of private financial institutions crumbled. They would bury it in a coffee can in the back yard, or perhaps sew twenty-dollar bills into the lining of a suit. Clearly, in these cases, the saving has been withdrawn from the

financial system and so total demand as commonly measured fell. However, this cautious financial behavior lends no support for increased deficit spending. There is nothing about a government going deeper into debt that is going to instill such confidence in a coffee can-based saver as to entice that person to disinter his or her cash just to make it available to the government.

Unless the saving has been withdrawn entirely and held in cash, it remains part of the financial system, and banks and other financial institutions are lending those monies to someone else to use. Companies today with large cash hoards are choosing not to invest these monies themselves in expanded productive capacity; however they are not locking them in the Chief Financial Officer's office safe, either. These corporate savings are deposited with and deployed by the financial system.

Why Are Demand-Siders Not Quaking?

The Congressional Budget Office recently released its analysis of the near- and intermediate-term budget picture showing a budget deficit for 2011 of almost $1.5 trillion or 9.8 percent of our economy.[1] However, under the CBO forecast based on current law, the deficit drops dramatically to 7 percent of our economy by 2012 and it drops a similar amount as a share of the economy by 2013. The Administration's Mid-Session Review released last July showed a similar pattern.[2] (This testimony was written prior to the release of the President's Fiscal Year 2012 Budget, which presumably will show the same general pattern.)

In light of these forecasts, if the Administration and other demand-side stimulus proponents believed their own theory they would today be concerned to the point of apoplexy. Rather than forecasting reasonably good growth for 2011 and 2012, they would be forecasting a growth recession at best, and more likely a return to recessionary conditions.

The measure of the amount of demand-side stimulus is whether the deficit is rising or falling relative to the size of the economy. From 2008 to 2009, the ratio of the deficit to Gross Domestic Product (GDP) rose from 3.2 percent to 9.9 percent. This 6.7 percent massive dose of fiscal stimulus represented the largest deficit burst since 1942. It was half again as large as the next biggest dose in the post-war era—a 4.4 percentage point burst in 1949. If demand-side stimulus worked, the economy's growth today should be China-esque.

On the flip side, a 5.5 percentage point drop in the deficit-to-GDP ratio from 9.8 percent in 2011 to 4.3 percent in 2013, as CBO forecasts, should raise loud alarms amongst demand-side supporters. If demand-side deficit-soaring stimulus works to boost

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[1] See Congressional Budget Office, "The Budget and Fiscal Outlook: Fiscal Years 2011 Through 2021," January 2011, at *http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf.*

[2] See Office of Management and Budget, The White House, "Mid-Session Review, Budget of the United States Government, Fiscal Year 2011," July 23, 2010, at *http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/11msr.pdf.*

the economy, then a rapidly shrinking deficit should undercut the economy. Yet, no such concern is in evidence. Instead, the Administration forecasts a steady improvement in output and employment. The Administration apparently no longer believes in demand-side stimulus.

To be clear, a rapid decline in the budget deficit through a combination of strong spending restraint and revenue recovery through economic growth is exactly what the nation needs today. The point, in the current context, is merely that demand-side supporters apparently expect as little downward effect from the rapid drop in the deficit's share of our economy as we saw stimulative pressures when the deficit began its historic ascent.

The Fall, Rise, and Fall of Demand-Side Stimulus

It was not that long ago that demand-side stimulus was generally understood to be ineffective. After a couple decades of unsuccessful attempts at fiscal fine-tuning in the 1950s through the 1970s, not just in the United States but around the world, a reluctant consensus for abandoning these policies developed. For some reason, this consensus fell apart during the recession President George W. Bush inherited from President Clinton. While Bush emphasized the importance of rate reductions, it also became acceptable again to talk about "putting money in people's pockets so they could spend." Demand-side stimulus was back, and as ineffective as ever as we learned in 2001 and 2002.

The demand-siders remained ascendant as President Obama took office and as yet another recession unfolded. Facing a choice of cutting tax rates à la first President Reagan in 1981 and then Bush in 2001 and 2003, or returning to the deficit spending policies of the early post-war period, Obama and his congressional allies naturally chose not to emulate their ideological opponents. They chose to increase mightily an already rapidly growing spending bulge and budget deficit. If ever this policy was going to work, this was it. It failed.

That demand-side stimulus has again failed is increasingly obvious even to those who advanced the policy, some reluctantly, some with gusto. It is safe to predict that many of those who remained silent in opposition will soon come out and say they opposed this policy all along. It is even safe to predict that some of the loudest proponents will recant in some future year, likely asserting in all seriousness and hoping no one will check, that they knew all along that the President's demand-side stimulus policy was doomed. It matters far less that these voices will still have currency in certain quarters than that, for awhile at least, demand-side stimulus policies will again be tabled as effective only in growing the national debt.

Stimulus That Would Have Helped

There is much the last Congress could have done to stimulate the economy. A simple example is that Congress might have acted quickly, rather than waiting until the

last minute, to extend the Bush tax cuts through 2012. The uncertainty surrounding tax policy slowed the recovery.

The Congress could have resisted the temptation to tinker. For example, it could have resisted the temptation of the first-time homebuyer's credit, which on balance slowed the recovery in the housing sector by first confusing and then slowing the price discovery process. To be sure, home sales at first increased, and then collapsed, and in the meanwhile housing markets had a powerful new source of market noise to filter out as they searched for proper price levels.

The Congress and the President could have halted the storm of new regulations and threatened regulations, beginning but not limited to Obamacare. According to estimates by my colleague James Gattuso, the cost of the federal regulatory burden now tops $1 trillion—before Obamacare.[3]

Above all, Congress could have focused its fiscal policies on the sources of recovery and growth, rather than give in to the perennial delight of increasing spending on politically favored causes. One example among many is that the Congress could have cut the corporate income tax rate from 35 percent to 25 percent for a decade for about the same deficit impact as all the so-called fiscal stimulus. President Obama acknowledged in his State of the Union address that the corporate tax rate is too high. Had he acknowledged this two years ago and pressed for a reduction at that time, many more fellow citizens would today have gainful employment.

Because the budget deficit today is so enormous, the nation's policy options aside from halting or reversing the regulatory onslaught are severely limited, confined essentially to expanding free trade and cutting spending deeply to restore fiscal balance. Near-term efforts to cut non-security discretionary spending are essential, but must be seen as but the first step in a steady march against government spending, including reforming the major entitlement programs to stabilize these programs and to stabilize government spending. The best Congress and the President can do now in terms of fiscal policy is to get the nation's fiscal house in order by cutting spending, repeatedly.

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[3] See James L. Gattuso and Stephen A. Keen, "Red Tape Rising: Regulation in the Obama Era," by Heritage Foundation *Backgrounder* No. 2394, April 8, 2010, at *http://www.heritage.org/research/reports/2010/03/red-tape-rising-regulation-in-the-obama-era.*

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Primary focus: Long-term changes in tax policy to ensure a strong economy, reforms to Social Security and Medicare so they are both affordable and more effective, and economic policy generally.

Foster came to Heritage in 2007 after serving many years at the White House, the Executive Branch, Capitol Hill and private policy institutions. His last job before joining Heritage was at the White House's Office of Management and Budget, where he was Associate Director for Economic Policy.

While there, Foster led the office's economic policy staff and advised three Directors on developments in the economy and potential changes in economic policy. He was also the chief adviser to the Director on matters of tax policy and led the OMB team in the Administration's "Troika" economic forecasting process. In addition, he played a leading role in the development and advancement of the Administration's pension and private health care policies.

Before joining OMB in June 2002, Foster served at the Treasury Department, where he was Senior Adviser in Economics at the department's Office of Tax Policy. He also advised the Assistant Secretary on issues concerning the 2001 tax cut, the 2002 tax stimulus bill, reform of the tax expenditure presentation in the President's budget, simplification, and options for tax reform.

On Capitol Hill, he was the Legislative Director for Rep. Philip M. Crane (R-IL), then Vice Chairman of the House Ways and Means Committee. Before that, he was the Executive Director and Chief Economist at the Tax Foundation, a Washington, D.C.-based research and education institution. While at the foundation, he saw its research program and reputation restored, a variety of new education programs instituted, and its debt retired. He also was Chief of Staff to Chairman Michael Boskin at the President's Council of Economic Advisors at the White House.

Prior to joining the Council of Economic Advisors, Foster was:

- Economic Counsel to Sen. Steve Symms (R-ID) and working on the Senate Finance and Budget Committees, 1991.
- Staff Economist at the Senate Republican Policy Committee under Sen. Don Nickles (R-OK), 1991.
- Economic Counsel to Sen. William Armstrong (R-CO) and working on the Senate Finance and Budget Committees, 1989-1990.
- Staff Economist at the Institute for Research on the Economics of Taxation, 1985–1989.

Foster received his doctorate in economics from Georgetown University, his master's degree in economics from Brown University, and bachelor's degrees in economics and mathematics from the University of Colorado.

Committee on Oversight and Government Reform
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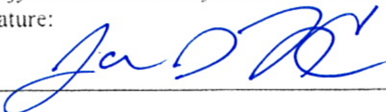

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