CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080   Fax: 202-408-1056   center@cbpp.org   http://www.cbpp.org

STATEMENT OF JOSEPH STIGLITZ
CO-WINNER OF 2001 NOBEL PRIZE IN ECONOMICS

at Center on Budget and Policy Priorities Press Conference
October 12, 2001

The subject I want to talk about is the current economic situation in the United States and the types of policies that might address the problems we face today. As I think all of you know, the economy was going into a significant slowdown, if not a recession, on September 11th. There is very little doubt that today the U.S. is in a recession. Although a recession is not officially a recession until the National Bureau for Economic Research says it is, the likelihood is that we are in one. Today's data on the dramatic decline on sales certainly confirms those concerns that we are indeed in a recession.

There is a consensus that something needs to be done. But what? I believe the U.S. economy is extremely strong and will recover from this downturn just as it has recovered from every other downturn. The question is how we can make that downturn as short and as shallow as possible.

What I will do here is list a set of proposals that I think would do precisely that. The kinds of proposals that are currently being discussed both by the Administration and today in the House Ways and Means Committee do *not* do that. They are not a set of proposals, with a couple of exceptions, that really address this country's needs.

Principles for a Stimulus Package

Let me begin, though, by setting out four principles that should guide us in looking at any specific proposal that is put on the table. There is a broad consensus on most of these.

First, any stimulus measure should be effective. It should work fast, during the recession. We'll be out of the recession in two to three years, so something that will take two to three years to work is irrelevant. It has to be fast, and it has to have a big "bang for the buck."

We know that there is concern about the long-term fiscal situation of the United States. The numbers that have come in in the last few months have certainly raised concerns. We are, in some sense, back in the situation I faced when I was on the Council of Economic Advisers back in 1993: we have to think about the long-term fiscal implications of any action we're taking. At that time, we spent a lot of time thinking about measures that were called "low-cost stimuli," or stimuli that had a big bang for the buck. That is, I think, one of the major criteria we should be thinking about.

Second, any stimulus measure should be fair. The September 11 attack has brought Americans together, probably more than ever before. There is an emotional feeling, I think, that all of us have toward those firemen and policemen who risked their lives for others. In that context, the benefits from a tax cut or a stimulus package ought to be evenly distributed. It is not fair if a lot the tax benefits go to a few rich people. That will undermine the sense of consensus, the sense of shared feeling that has been brought about by the recent events.

Third, any stimulus measure should be temporary. We should not use our current economic problems as an excuse for measures that otherwise would not have been adopted, and we should not use a short-term crisis for solving long-term problems.

Fourth, to the extent possible, any stimulus measure should be consistent with this country's long-term needs and should not exacerbate its long-term problems. For instance, we have a long-term problem with financing Social Security. Anything that worsens the financial situation of Social Security will contribute to our long-term problems.

A Five-point Stimulus Plan

Now I will outline a five-point stimulus program that is consistent with those principles.

First, we should extend the duration and magnitude of the benefits we provide to our unemployed. The unemployed, in a situation like this, are innocent victims. Most of the people being thrown out of work *want* to work, but our economy is not providing them jobs. Why should they suffer because of economic mismanagement?

This is not only the fairest proposal, but also the most effective. People who become unemployed cut back on their expenditures. Giving them more money will directly increase expenditures.

Since our "safety net" is worse than that of most other industrialized countries, we also need extensive improvements in health care, food stamps, and other kinds of programs. For eight years, the most important part of our safety net has been full employment: people who were let go could get another job because we had such low unemployment. That is not going to be the case for the next six months to a year and a half. That part of our safety net has gone, and we need to put into place an alternative one.

Second, we need a temporary investment tax credit or expensing, something to stimulate investment. Making it temporary encourages people to make the investment today, when the economy needs it and when our resources are not fully utilized. In 1993 we designed an investment tax credit revision that had a huge bang for the buck. It's called an incremental investment tax credit, and I strongly support moving in that direction.

Third, we ought to have better backward averaging of taxes, particularly corporate income taxes. This is one of the proposals being discussed within the Administration. One reason why there has not been better backward averaging in the past is tax avoidance; to avoid this problem, it should be limited to those firms engaged in investment activities. If these firms were allowed to have a significantly longer backward averaging, that would help provide them with the funds to invest more.

Fourth, we need a more extended program of revenue sharing with state and localities. Let me explain why that is so important. State and local expenditures are pro-cyclical: when the economy goes into a downturn, states and localities typically cut back on their expenditures. (The reason for this has to do with their budgeting structure; many states have balanced budget amendments, for example, and are forced to cut back.) This not only weakens the vital public services that are provided at the state and local levels, but also deepens the economic downturn.

We could put money into the states and localities very quickly through a revenue sharing program that would enable them to avoid the kinds of cutbacks that would affect every part of society. It would be particularly good to direct funds to areas of particular need, like Medicaid and education. There are a whole host of vital needs that are typically provided by state and local programs.

Fifth, there needs to be an increase in expenditure in high-return areas. When I was at the Council of Economic Advisers, we did an analysis of investment in the public sector. It was very clear that there were areas in the public sector that were starved for funds and where returns were very high. For instance, the air traffic control system was woefully inadequate; investments in that area would yield very high returns. We have inner-city schools that are dilapidated; kids cannot learn in the kind of environment some of them face. These are areas in which programs are already underway but in which expenditures can be increased.

The House Ways and Means and Administration Stimulus Proposals

Now let me spend some time on four of the provisions that have been talked about either in the Administration or in the House Ways and Means bill that I think would *not* be effective and would violate one or more of the principles I outlined earlier. First is accelerating the reduction in income tax rates. This is an unfair proposal in a very common-sense kind of way. Take a person with an income of $50,000 — the kind of income that the firemen who gave their lives received. How much would that person get from this kind of proposal? Zero. What about somebody struggling to get along on an annual income of $5 million? Over four years, this proposal could give that person $600,000. (This is the tax cut such an individual would receive if all of the tax rate reductions scheduled for 2004 and 2006 are moved up to 2002.) Just think about the inequity. We're supposed to be coming together today, but this proposal does not do that.

Moreover, it is not going to be very effective. We have some data on what happened to the tax refund that was already given: people put it, by and large, in the bank. You see almost no impact on national consumption. Giving income to upper-income individuals is not going to have a significant effect on consumption. It will only help some people's bank accounts.

Second, there's a proposal for permanent partial expensing. Not only does that violate the principle that we should be focusing on the problem today, which is the need for immediate stimulus, but it turns out that permanent expensing is less effective than temporary expensing. Why? Because people say, "Why invest today, while there's uncertainty, when I can get the same tax reduction if I wait two or three years until things get straightened out?"

Third, there is a proposal to eliminate the corporate Alternative Minimum Tax. The problem with this is that most of the benefits accrue to old investment. You want to target something that encourages new investment instead.

Fourth is a cut in the capital gains tax. There are lots of problems with this. It has, first, the same problem as the corporate AMT proposal: most of the benefits from reducing capital gains taxes go to investments made five to ten years ago. Also, it could well be counterproductive. If people take advantage of the capital gains tax cut and cash in their shares, but instead of putting their money back into the stock market they park it in a place they feel is temporarily safer, it's going to have a negative effect on the stock market and exacerbate the economic plight we have today. Finally, a capital gains cut is extremely unfair. Eighty percent of the capital gains go to the top two percent of our population. So it violates the principle of fairness as well.

Many of these provisions also violate the principle of not exacerbating our long-term problems. This country is worried about its long-term fiscal situation. Many of these proposals would not only eat into our Social Security surplus but lead us to have an actual deficit. They would reduce our total worth and weaken our overall fiscal position.

And it's not just what we think about the long-term fiscal situation; what foreigners think matters too. We have a huge trade deficit and are borrowing hundreds of billions of dollars every year. If foreigners lose confidence in the United States, they will take their capital back and our interest rates will go up.

When the large tax cut was adopted not that many months ago, many of us thought it was imprudent. I've worked with budgetary numbers before and I know how unstable they are — as we say, "Easy come, easy go." Now we have a new fiscal situation. Would we have passed a tax cut of that magnitude if we had had the data available then that we have today? I don't think so. My point is that we need to recognize now the adverse effects these proposals will have on our long-term budgetary position.

Here's another way of thinking about it. The recovery in the 1990's was based on back-loaded tax increases and expenditure reductions. What we have here is just the reverse: back-loaded tax *de*creases and expenditure *in*creases. We can already see the impact on long-term interest rates. And as a result of those long-term interest rates, the stimulus effect on our economy of these tax cuts and expenditure increases is much smaller than it otherwise would have been.

Let me end with one idea that has not been put on the table but brings me back to one of my favorite issues: the IMF. As many of you know, the IMF was created under the aegis of thinkers like Keynes, who was aware that the economy sometimes goes through slow periods. Keynes argued that an institution is needed to help provide liquidity that would allow countries facing a downturn to stimulate their economies. We are now facing a global slowdown, the kind Keynes said he was worried about, but the IMF is still fighting last year's problem: inflation. It is time for the IMF to provide the liquidity that would allow for a global economic expansion.

This liquidity could be tied to global economic needs, the fight against terrorism, the fight for a better global environment, the fight for a more equal world, and/or reducing the disparity between the "haves" and the "have-nots." In other words, one can design a program of increased global liquidity and increased global expenditures that would be targeted at meeting some of our most important global needs. That would help not only the American economy but the global economy as well.