Accelerating Economic Recovery

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Conclusion: *After elections, Congress and the President will attempt to address the nation's fiscal problems. Farm commodity program spending will be scrutinized as never before.*

At the annual economic symposium sponsored by the Kansas City Federal Reserve Bank and held this summer at Jackson Hole, Wyoming, bankers and economists wrung their hands in frustration over the persistent torpor of the American economy. Neither monetary nor fiscal policies-- traditional means to avoid or ameliorate downturns in the business cycle--have succeeded in lowering the stubborn 8 percent unemployment rate. This brief addresses policies including reforms in fiscal policy institutions to overcome the nation's economic lethargy.

Monetary Policy

The Federal Reserve Bank (Fed) has held its traditional economic stimulus--interest rates on "overnight" lending among banks--to near zero for months. Meanwhile the unemployment rate has remained at near 2 percentage points above the "full employment" level. Businesses have held up to $2 trillion in earnings on reserve, waiting for attractive investments but finding few and constrained by pessimistic expectations fueled by a steady stream of new federal regulations, tax-hike threats, continuing out-of-control deficit spending by the federal government, and depressing economic news from the Euro zone.

What's wrong with this strategy? Since the Keynesian revolution of the 1930s up to the 1980s, Keynesians argued that expanding the nation's money supply and tolerating some inflation could bring an economy to full employment. Milton Friedman is especially noted for exposing the futility of such a policy. He concluded that "Inflation is always and everywhere a monetary phenomenon". Continued monetary stimulus does not promote full employment—it just brings inflation. People and firms learn to anticipate forthcoming inflation as money supply expands and take measures such as saving money and foregoing consumption to preserve their wealth. Potential buyers of government bonds demand an interest premium plus a real return, so interest rates rise with inflation, discouraging savings. The result in the 1970s, for example, was "stagflation"—high inflation coupled with high unemployment and idle production capacity. Paul Volcker, chairman of the Federal Reserve Bank (Fed), recognizing that inflation does not bring full employment, ended the policy of expanding money supply to create jobs. The "cost" of bringing down inflation was a recession in the early 1980s. Inflation and inflationary expectations were tamed and the stage was set for a long period of economic growth without inflation.

Now that the Fed has driven interest rates to near zero, what can it do to stimulate the economy? The answer is to "print money". On September 13, 2012, Chairman of the Fed, Ben Bernanke, announced that the bank would undertake a third round (QE3) of "quantitative easing", an effort to stimulate the moribund economy by "printing money". The Fed plans to spend $40 billion per month over an unspecified number of months buying mortgage bonds presumably until the economy jump-starts after previous attempts failed. The first such effort (QE1) began in late November, 2008 when the Fed bought up mortgage backed securities and Treasury bills for a total of $2.1 trillion of assets by June 2010 (Crutsinger, September 14, 2012, p.A11). QE2 followed in August 2010, injecting an additional $600 billion into the economy. The Fed also pledged to keep short-term interest rates very low through mid-2015.

More money chasing available goods and services eventually causes prices to rise. With anticipated inflation, consumers expand their purchases now to avoid paying even higher prices in the future. By bringing inflation rates above interest rates, the Fed brings negative interest rates to further stimulate investment and hence the economy. The economy currently has enough excess labor and other resource capacity to create competition for employment and thus keep inflation at low levels despite the major monetary stimulus. Consumer's demands can be met with minimal inflation until the economy achieves "full" employment—about 6 percent unemployment in today's economy.

Printing money to create inflation and economic growth is a high risk strategy. One problem is that consumers anticipate inflation and build savings to cope with an uncertain future. Such behavior retards consumption, investment, and employment. Another problem is that retirees and others who live off fixed nominal incomes suffer lost buying power. They punish their political representatives in the voting booth. A monetary policy of printing money becomes politically unsustainable and if carried to extremes could make the U.S. economy resemble the German Weimar Republic of the 1930s.

Fiscal Policy

With monetary policy a useful but limited tool to revive a moribund economy, attention turns to the other major policy tool—fiscal policy to manage government revenue, expenditures, and the balance thereof. The standard conceptual foundation for fiscal policy is Keynesianism, named after the British economist John Maynard Keynes. At the heart of Keynesianism is the contention that consumers anticipating an economic downturn cut consumption to save for the "rainy day". Resulting low demand for goods and services causes firms to cut back employment and investment. Excessive saving and high unemployment foster a downward spiral into economic recession or depression. Presumably the role of government in this situation is to offset the lack of private aggregate demand with government spending. Government must print or borrow money to fund deficits so that taxes will not dampen the stimulus.

Keynesian fiscal stimulus is closely analogous to a highly addictive hard drug. The patient does more than "feel no pain"; he feels euphoric with early doses. Subsequent doses produce no euphoria as the body develops immunity to the drug. Ever larger doses are necessary to produce highs. By this time, the subject is highly addicted and must continue high dosages just to feel normal. Escalating doses eventually build to a lethal level. The craving for the hard drug is never overcome, but competent intervention accompanied by strong motivation by the patient to rehabilitate can salvage the situation, albeit with severe organ damage and pain to the recovering addict.

The federal government is a deficit junkie. The urge to consume now and let future generations pick up the tab is irresistible to Democrats and Republicans alike. Federal expenditures have exceeded receipts almost every year for decades and are destined to continue to do so in the foreseeable future. The current fiscal policy is unsustainable, however. Federal debt currently is increasing 8 percent annually and national income is increasing only 2 percent annually. If the current deficit rate continues, interest on the federal debt will eventually exceed national income. Debt accumulation will stop well short of that outcome. China, Japan, oil exporting countries, and other creditors will lose faith in our nation's ability to service debt and will no longer lend at affordable rates. Creditors will stop lending or demand prohibitively high interest rates, causing an international financial meltdown from U.S. debt default.

Deficit spending can be justified to finance high payoff investments, for example, in much needed infrastructure. Saving General Motors and Chrysler helped to save jobs and avoid a depression. But most of the annual deficit is spent on items with low payoff that will not generate income to ease the burden of paying off debt by future generations. Without a major redirection of policy, the U.S. will become another Greece with attendant reductions in credit ratings, rise in interest rates, cutbacks in government programs of all types, economic depression, and nationwide drop in living standards.

Some Keynesian economists such as Paul Krugman contend that the economic stimulus (some $800 billion earlier in the Obama Administration) was not large enough. Overlooked is the ongoing stimulus of the federal deficit now running $1.3 trillion per year. Americans are learning to anticipate the future debt service costs and painful adjustment to living within the nation's means and are saving for the future by cutting personal spending. The massive current drug dose ($1.3 trillion annually) is no longer producing a high but a cutback promises to be a withdrawal too painful to contemplate. Meanwhile the nation is about to embark on a needed but very costly national health care program with a disturbing lack of cost controls.

Policy Reform

I elsewhere (Tweeten 2007) have listed in some detail the prescription of policies for a successful economy. Space limits preclude reprising that list. Several reforms in monetary-fiscal

policies need elaboration, however, as explained below. The foregoing discussion indicates that monetary policy has gone about as far as it can and fiscal policy is hopelessly mired in partisan political stalemate. An argument of this brief is that monetary-fiscal policy will efficiently revive the nation's economy only with major policy reform. Markets are the core of a successful economy, but work best in a supportive institutional environment. Similarly, monetary-fiscal policies work best in a supportive institutional environment.

Before proposing a framework to make monetary-fiscal policy and markets function effectively to revive the economy, it is useful to review how policy can undermine an economy. Economist Mancur Olson (1982) recognized that an economy is like a ship. That is, it is sleek and swift when new but inevitably accumulates barnacles as the years pass. This slows the vessel so that other, newer ships pass it by. So it is with nations and the policies (barnacles) accumulated as special interests pursue self aggrandizing policies to the detriment of the national economy. It is said that "There is nothing as permanent as a temporary government subsidy".

A U.S. example is the well intentioned but toxic Community Investment Act of 1977. This Act and follow-up legislation were intended to provide America's poor and minorities housing ownership but instead caused housed investment overshoot and the Great Recession. That Act required banks and other lending institutions to lend as generously to poor and minority households as to other households in their market area. Banks and other lenders had to lower standards to increase their lending rates to the poor and minorities with low credit scores. Interest rates were higher than on normal mortgages, but risk was great. The risk to financial markets was compounded (upon the urging especially of Senator Phil Gramm) with repeal of the *Glass-Steagall* law dating from the 1930s. That law separated banks into *conventional banks* taking deposits and financing mortgages from *investment banks* that were allowed to bundle mortgages into securities traded widely in financial markets. When subprime "ninja" mortgages (no income, no job, and no assets) were bundled into inscrutable securities (called credit-default swaps), they readily attracted buyers—in part because the securities received bogus favorable credit scores from rating agencies and were insured against default by insurance firms such as AIG. Unfortunately, the insurers lacked capital to cover losses when the housing market "turned south". The flawed institutional arrangement worked when housing values were rising, but failed spectacularly when home values fell and mortgages exceeded the market value of the houses. The taxpayer and homeowner bore much of the cost of foreclosures, but the entire economy suffered from collapse of the overbuilt housing market. Consumers had used their homes as collateral for home equity loans. By 2007 debt averaged over 120 percent of consumers' incomes. The painful and slow process of deleveraging their finances to a sustainable balance sheet required a cutback in spending with resulting pain to households and the national economy alike.

Faced with out-of-control federal deficits, Congress passed the Budget Control Act of 2011 to trim federal spending by $1.2 trillion over 10 years and raise federal taxes to the higher levels

prevailing before the tax cuts enacted during the administration of President George W. Bush. This so called "fiscal cliff", to be implemented January 2, 2013, was designed to force Congress to enact a more sensible phase-in of reforms that would not return the nation to recession. Although the deficit reduction was only 10 percent of the expected increase in federal debt over the coming decade, politicians recoiled in panic over prospects for the economy and voters of even this small reform. The deficit "drug habit" is indeed difficult to break once entrenched. Various groups have proposed policies to restore fiscal responsibility, and some proposals place agricultural subsidies on the chopping block.

I have argued elsewhere (Tweeten 2011) that "Washington" is hard-wired to concoct policies detrimental to the economy. Enacting and managing federal fiscal policy requires expertise far in excess of Congress' capabilities. One commonplace reform proposal is for an amendment to the constitution requiring the federal budget to be balanced each year. That policy is unworkable because it creates rigidities interfering with the ability of the federal government to smooth the business cycle and respond to unforeseen exigencies. An alternative is sketched below.

I have proposed that size of the federal deficit be set each year by professionals a step removed from the political process. A "Federal Fiscal Policy Committee" (FFPC), patterned after the Federal Open Market Committee regulating the money supply, would specify a federal deficit target for the coming year(s). Any shortfall will be made up the following year by an across-the-board increase in taxes and/or a reduction in spending. Members of the Committee would possess appropriate macroeconomic policy expertise and would be appointed for (say) 10 year staggered terms by the President with approval of Congress so as to be at arm's length from the political process. Given the importance of coordinating monetary and fiscal policy, at least one member of the Federal Open Market Committee would also serve on the FFPC. Congress and the President would continue to set the level and distribution of taxes and expenditures—just not the size of the deficit. Congress and the President would establish rules for the Committee, including qualification for and appointment of Committee personnel, operating guidelines, disclosure rules, how to address emergencies, penalties for failure to follow guidelines, and the like. Versions of such a committee currently operate in Brazil, Chile, Hungary, and Sweden.

A chief criticism of the FFPC proposal is that Congress will never sacrifice that much control over the nation's economy. Yet Congress has demonstrated such willingness by turning control over the nation's money supply and inflation rates to the Federal Open Market Committee. Asking the current generation of Americans to pay for the public services they receive is not a harsh mandate.

The proposed Federal Fiscal Policy Committee providing budget deficit discipline would not alone revive the flaccid economy. Revitalizing the economy requires changes in the structure of taxes and expenditures. I (Tweeten 2007) have elsewhere presented in some length a prescription for policies and institutions with a proven record for growing an economy. I (Tweeten 2011) also

have outlined reforms in tax and other policies to provide greater efficiency and equity in the nation's economy. Examples include replacing the corporate income tax and federal payroll tax (both of which retard investment and employment) with a value-added or national sales tax. The estate tax could be replaced with an inheritance tax, the latter included in an overall gift tax paid at the same rate as on ordinary income.

Other proposed reforms have similarities to those of the Simpson-Bowles Commission. Dividends and capital gains (with an option to pay on *real,* inflation adjusted*,* gains only), and gifts (including inheritance) would be taxed as ordinary income and exemptions would be cut or removed for home mortgages, municipal bonds, charitable contributions, health insurance, and oil and gas industry "manufacturing" subsidies. With these changes, overall marginal income tax rates could be reduced, enhancing economic efficiency.

Conclusions

Numerous groups and individuals have proposed reforms to reduce deficits and revive the economy. In fact, reforms must be much bolder and far-reaching than those proposed to have much impact. Recovery from a recession typically has two phases. The first tries to stimulate *demand* and discourage savings through deficit spending and related policies. The second phase is *supply* side emphasis, relying mostly on markets to encourage consumer savings and allocate resources to uses providing benefits in excess of costs. Getting that transition right is well beyond the capabilities of the nation's political bodies. This brief proposes several fiscal policy institutional reforms to promote national economic growth with equity.

The 2008 farm bill expired September 30, 2012. If a new legislation is not enacted, the nation will return to the unworkable and hence politically unacceptable 1949 farm bill. Agricultural subsidies cannot escape scrutiny under any fiscal policy reform, but the economic pain to farmers is likely to be less if farm policy changes are made early in a legislative environment of orderly policy reform rather than wait for a national or global financial crisis.

The competitiveness rating of an economy is closely correlated with its per capita national income and living standards (World Economic Forum, September 8, 2012, p. 59). Hence it is worrisome to see the United States drop one place among world nations in each of the last four years and currently ranks seventh most competitive. It is outranked by Switzerland, Singapore, Finland, Sweden, Netherlands, and Germany. Competitiveness is measured by performance of infrastructure, institutions, financial systems, labor markets, financial systems, innovations, and public services. Congressional stalemate and general sclerosis in the U.S. economy allows "barnacles" to accumulate on the "ship of state". In the absence of reforms such as outlined in this brief, the nation will continue to lose competitiveness.

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