Testimony of
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Thank you, Mr. Chairman and members of the Committee.

As I was preparing this testimony, it occurred to me that if you reverse the word "outlook," you get "look out!" That's a bit the way I feel about the outlook for the U.S. economy right now. Forecasting the economy's near-term future has always been a hazardous occupation; the usual uncertainties are daunting, and precision is out of the question—except by luck. But today we have, layered on top of the usual *economic* uncertainties, a host of extremely unusual, indeed unprecedented, *geopolitical* uncertainties--all of which make forecasting nearly impossible at the moment. But frankly, I'm worried about the downside risk.

There is, I hasten to say, a happy scenario leading to a sharp V-shaped recession and recovery. But I call this the "everything-goes-right" scenario because among the things that must happen are most or all of the following:

1. Congress must pass a sensible stimulus bill—one that really stimulates the economy—in short order.
2. Oil prices must remain low.
3. There must be no more serious, confidence-shattering acts of terrorism in the United States.
4. The war in Afghanistan must continue to go well.
5. The war must not spread to the Persian Gulf (e.g., to Iraq), which could cause another oil shock, or, say, destabilize Pakistan.

In this "everything-goes-right" scenario, we might have a negative fourth quarter, a first quarter of 2001 with real GDP growth either slightly positive or slightly negative, and then start registering substantially positive growth numbers in the second quarter and thereafter. The recession of 2001-2002 would then be no worse than, and probably milder than, the recession of 1990-1991. The reasons for this optimistic view are well-known: Falling oil prices, monetary policy, and fiscal policy are all stimulating the economy, and inventories have been drawn down to very low levels—which should lead to a strong inventory upswing once sales start to recover.

This is the scenario I hope for, but not the one I believe in. Quite honestly, I don't know how to attach probabilities to the various events that underlie the "everything-goes-right" scenario. But I am worried that the joint probability that *all* of them turn out favorably is not high. That's what I meant before by *downside risk*. And this downside risk is the main reason why I believe Congress should enact a stimulus bill *right now*. If one or more of the things on my list goes wrong, we could be in for a severe and perhaps lengthy recession. Remember:

-- the economy was very weak *before* September 11th, only the intrepid American consumer was keeping the economy afloat;

-- the terrorist attacks were a blow not only to consumer confidence but, much more importantly, to jobs and income;

-- the standard cycle of lower spending leading to layoffs, which in turn to lead to still lower spending has barely begun;

-- the slowdown is a worldwide event; we will not get any help from abroad.

The solution to the U.S. recession must be made in the USA. The Federal Reserve is doing its part; I tip my hat to them. But the well-known lags in the effects of monetary policy mean that the steps the Fed has taken since September 11th will be relevant only to the shape of the *recovery*, not to the severity of the *recession*. There are, however, *fiscal* measures that can impact the economy much sooner than that—if only Congress would enact them. That is why I became a strong advocate of fiscal stimulus on September 12th.

Many economists and other citizens are dismayed that Congress has been dithering over the stimulus for more than two months and now appears to be deadlocked. When I read in the papers about tax cuts or spending programs that might take effect in the spring, or even later, I wonder what Members of Congress can be thinking about. This is not a partisan remark; both Republicans and Democrats are to blame. But it is well passed time to get beyond partisanship and enact a genuine stimulus bill. I realize that the JEC has no jurisdiction in this matter. But every member of this committee is among the 535 men and women who must ultimately get something done. And Congress is already running late.

I would like to suggest two simple and nonpartisan tests to determine whether some proposal is really an appropriate part of a stimulus package in the current environment:

1. *Scorekeeping*: Is at last 80% of the cost incurred in the first year? (I'd actually prefer 100%.) If not, the economy is probably not going to get much stimulus bang for the budgetary buck.

2. *Customization:* Were the people who are now advocating the policy also advocating it a year or two ago, and will they also want it a year or two from now? If so, it is probably not tailored to the current situation.

Proposals that fail to meet these two criteria may or may not be sound policy—that will be a matter of debate, often partisan debate. But they cannot legitimately be considered short-run stimulus. And you are all aware that most of the proposals included in the House bill, and several of those under consideration in the Senate, fail one or both of these tests.

With your indulgence, I'd like to outline my own suggestion for breaking the deadlock in a bipartisan way. I first made it in an op-ed piece in *The New York Times* exactly two months ago.[1] My proposal is that Congress offer to replace the revenue lost by any state that reduces its sales tax by a certain amount for a certain, well-defined period of time. When I made the proposal originally, I suggested a cut of 1 or 2 percentage points for one year. But, especially now that time has elapsed, I can see a case for a shorter time period and a deeper cut—perhaps 2-4 percentage points over six months.

Some of you may be familiar with a first cousin of this proposal, which has been offered by Senators Murray and Snowe. Their proposal would declare a sales tax *holiday*, that is, drive the tax rate all the way to zero, but for only 10 days. The *spirit* of their proposal is exactly right, and it passes my two tests with flying colors. I applaud them for making it. But our economy is not facing a 10-day problem. The central idea behind a *temporary* cut in sales taxes is to induce consumers to bring their spending forward--into the low-tax period. But we won't shorten the recession if consumer spending booms for 10 days and then sags on day 11. If you start with their proposal, but lengthen the 10-day period and reduce the depth of the rate cut, you begin to move toward my proposal. There is plenty of room in the middle.

A temporary sales-tax cut has many virtues. Notice, first of all, that it is strikingly nonpartisan. For Republicans, it's 100% tax cut, not government spending—and it's a *marginal* tax rate reduction to boot. For Democrats, it's a cut in a tax that has long been viewed as regressive, and it delivers help to those who need it most. It is no coincidence that the co-sponsors of the Murray-Snowe proposal are one Democrat and one Republican.

Second, the proposal cuts taxes *only* where tax cuts do the economy some good. Every dollar of tax cut would be directly attached to consumer spending—which is where, I believe, we should concentrate our fire. At given income levels, people who spend more will benefit more. And those Americans who live from hand to mouth, spending every dollar they earn, will get a tax cut on every dollar.

You might well ask, "Doesn't the so-called 'Supplemental Rebate' for low-income households also deliver help to the needy?" The answer is yes, and I favor it. But we must remember that making an *income tax* cut temporary *weakens* its impact on spending (as we saw with the recent tax rebate), while making a *sales tax* cut temporary *strengthens* it (as many cities and states have recognized). This incentive effect is the third important virtue of the proposal.

Fourth, the sales-tax cut is as simple legislatively and administratively as can be imagined. The structure of the tax in each state is already set up, as is the reporting and

[1] Alan S. Blinder, "The Economic Stimulus We Need," *The New York Times*, September 28, 2001.

collection apparatus. Congress would not tamper with any of that. At the state level, the necessary legislation could be one line long. In my home state of New Jersey, for example, it might read: "The basic rate of sales taxation is reduced from 6% to 4% for the six-month period January 1, 2001 through June 30, 2002." And once the statute is enacted, the tax cut can take effect very fast.[2]

Fifth, and related, a sales tax cut of this nature will convey a simple and intelligible message to citizens in a way that no complicated, hodge-podge bill ever can. Ordinary Americans, the kind who were so heroic on September 11th, understand the sales tax in a way they will never understand the corporate AMT or Medicaid provisions. They will not only see that Congress has actually done something to help the economy, they will immediately understand that the tax cut is designed to help them spend more.

Last, but certainly not least, this measure will improve the ailing fiscal positions of the states. Suppose a state reduces its sales tax from 6% to 4%, and the tax cut actually succeeds in increasing sales volume. If the Federal government then adds 50 cents to every dollar the state collects, the state's treasury will actually come out *ahead*. This feature of the proposal is no accident, but it should not be thought of as merely government-to-government charity. The fact is that state and local government budgets are normally procyclical; states and localities typically raise their taxes and cut their spending during recessions, and do the reverse during booms (as we have just seen). There is every reason to think that most of the states will behave this way during the current recession; indeed, many are doing so already.

When I published this proposal on September 28th, I was not expecting an immediate groundswell of support from both sides of the aisle. My hope was that, in the event of a partisan deadlock, Congress might look for a way out that was acceptable to both parties. We are now at that point. So I offer this proposal to any Democrat or Republican who will champion it.

Thank you, Mr. Chairman and members of the Committee, and good luck in your deliberations.

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[2] Five states do not have a general sales tax. Congress would no doubt want to make special provisions for these five. That is about the only complication that this proposal entails.