Lawrence Lindsey Testimony to the

U.S. Senate Democratic Policy Committee

December 16, 2009

<u>Maximizing Job Creation</u>

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Thank you, Mr. Chairman, for this opportunity to present my thoughts on the Employment Crisis now confronting America. It is serious, probably will get somewhat worse in coming months, and is now at the stage where lasting economic and social damage may result.

The central thought I would urge this committee to consider is that Quality is more important than Quantity in considering budgetary actions designed to ameliorate the crisis. With our budget deficit having risen from 1.2 percent of GDP in 2007 to 3.2 percent in 2008, to 10 percent in 2009 and likely to average over seven percent in the next decade, the country's room for fiscal maneuver is shrinking.

Qualitative analysis requires three steps: first, diagnosing the core root of our economic problem in order to focus fiscal actions there since unless that root cause is addressed, short term policies will be for naught; second, allocating resources toward sectors facing particularly weak aggregate demand and not toward areas where demand is strong, employment is growing and wages are rising; this is the essence of countercyclical "leaning against the wind"; and third, designing specific programs that are straightforward, transparent, and deliver maximum bang for the buck. I will consider each point in turn.

Qualitatively this recession is different from most post-War recessions. It was not the result of a tightening of monetary policy designed to choke off incipient inflation pressures. Rather, it was caused by a sharp downward change in asset prices that wreaked havoc on household balance sheets. Aggregate wealth loss for households by March 31 had reached $17.5 trillion. Accommodative monetary policy designed to raise asset prices has succeeded in recouping about $5 trillion of those losses thus far, but continued improvement is far from certain. When households are made poorer, they are forced to spend less and save more in order to recoup some of their wealth loss. Today, real consumption expenditures are still below their peak in April of 2008. Such a protracted decline in real consumption expenditures is extremely rare in the United States. Less consumption means firms invest less and investment is 26 percent below its peak. With less consumption and investment spending, firms necessarily cannot hire as many workers. So repairing household balance sheets is a necessary part of rebuilding employment.

This qualitative description of the problem led me to suggest last January that we halve the payroll tax for both employers and employees for two years. The budgetary cost of such a measure was roughly equivalent to what was spent on the stimulus package Congress ultimately passed. This payroll tax cut would have put roughly $1,200 in the pocket of a median wage worker with an equal sum going to his or her employer, thus lowering the cost of hiring by 3 percent. At the margin this would have led to a change in cash flow that was more directly tied to maintaining employment than would other, less direct, measures. In my opinion, any reorientation of current fiscal measures away from these more indirect approaches and directly toward payroll tax cuts would be the most efficient means available for this Congress to stimulate employment and begin the repair of household balance sheets.

Second, in allocating resources, Congress must bear in mind the notion of "leaning against the wind." Three sectors of the economy: government, health care, and education, have been relatively unaffected by the recession. In fact, total wages in the education and health care sectors have risen 9 ½ percent, compared to a decline of 3 ¼ percent in the rest of the private economy. Employment has risen 1.8 percent in those sectors while declining more than 5 percent overall. Yet most measures passed to date have allocated still more resources to these prosperous sectors while output and employment in the rest of the economy shrinks.

In doing this, I am sorry to say that America is emulating the pattern adopted by Japan in its balance sheet recession that began almost two decades ago. The direct allocation of resources from the government to politically favored industries did nothing to help the overall employment situation and prevented necessary industrial restructuring. It also meant that balance sheet repair did not occur. The lesson of Japan is that government, at a minimum, should allocate resources neutrally and not try and use politically favored sectors as a means of channeling demand.

Indeed, the problems with this approach are already obvious in the jobs numbers. The attached chart labeled, “Where are the Shovel Ready Jobs?” points up the ineffectiveness of politically based allocation of resources to particular sectors. The Labor Department reports employment in the Civil Engineering and Heavy Construction sector separately from other sectors. Despite efforts that were supposed to help this very sector, employment there has dropped as fast as it has in the residential and nonresidential construction sectors and much faster than in the overall economy. Again, a reallocation of funds away from politically favored projects and toward a more sector-neutral, but pro-employment purpose, like a payroll tax cut would be in keeping with the qualitative analysis of what is happening in the economy.

The third qualitative issue to be considered is program design. There are a lot of well intended ideas out there that seek to get maximum benefit from limited resources by carefully targeting the money. One of the most typical is an “incremental jobs” credit that would subsidize only additional workers who were added to payrolls. Back in my graduate student days I would have been a strong advocate of such an approach. But after nearly three decades of being involved with public policy, I have to say that the big risk is that such proposals turn out to be, as the British say, too clever by half.

On a substantive basis, these proposals are difficult for the intended beneficiaries to understand and difficult for those tasked with administering the program to implement. As a result there is often an attempt to game the rules by those with the wherewithal to understand them and a low rate of take up and utilization by those who were the intended beneficiaries. I think one great example of this problem has been in the myriad programs that the government has sponsored in the last two years on foreclosure mitigation and refinancing options. While I applaud the intent of such programs, the reality is that there were too many of them, the rules were too complex, the unintended consequences were too high, and the actual success rate has been far too low. Again, the payroll tax reduction is transparent, easy to understand, and difficult to game. Moving existing stimulus resources from more complex and less effective programs in that direction would be a significant step in the right direction.

In my remaining time, I would like to return to the issue of the deficit. At the moment our financial markets are characterized by an unprecedented involvement by the Federal Reserve to maintain a smoothly functioning long-term bond market particularly in the area of housing and by a variety of incentives for the commercial banking sector and other financial intermediaries to take up any remaining slack by borrowing at low overnight rates and buying higher yielding longer dated securities. This situation will come to an end either as the Fed exits, as it is scheduled to do by the end of March from its mortgage backed securities purchases, or because markets themselves will come to view the status quo as unsustainable. The cost of debt will then rise as government must crowd out other uses of funds.

So, all additional future spending plans, even those for 2010, should be viewed as largely crowding out non-governmental spending, not as net new spending. Crowding out occurs either through expectations of higher taxes, higher interest rates, or increased borrowing from abroad at the cost of a reduction in net exports. This was not the case a year ago, but results from the magnitude of the spending and borrowing done to date. A year ago I was a supporter of a fiscal stimulus measure of the magnitude of the one that passed, although I did not think that the actual measure adopted was the best use of available resources. As a consequence, I would urge that, in addition to maximizing the jobs producing quality of any program it passes, that Congress also make every effort to pay for additional jobs oriented measure in a way that is least damaging to private demand as possible. I have suggested that a reorientation of politically targeted spending programs into payroll tax reductions as one such approach. I realize that, politically, it is not likely to be done that way.

One idea now being advanced is to spend TARP repayments and TARP money that was never disbursed on a variety of stimulus programs. It is true that TARP losses on advances to the banking sector have been less than previously thought. But other financial-related losses that the government will almost certainly have to make up such as for the FHA and FDIC are almost certain to arise in 2010. In addition, the perilous condition of finances in many of our state and local governments is almost certainly going to create the need for some form of federal bailout during 2010. It would be inconsistent, and some might say intellectually dishonest, to count and spend money on programs that ultimately cost less than what they were originally scored at, while ignoring the budgetary costs of new bailouts that are on the way.

I would therefore urge this Congress to take a look at another measure it is considering. The House has passed a Carbon Emissions Cap-and-Trade program that is badly flawed in design. Let me stress that this comment is unrelated to the Climate issue, and focuses just on program design in the current environment. The trading scheme envisions a significant increase in the cost of carbon, but the legislation rebates an estimated 85 percent of the resulting revenue to the various polluters as a way of mitigating the economic impact.

A far more sensible approach would involve a somewhat lower net increase in the cost of carbon, at least initially, and imposing that cost through a carbon tax that Congress would control the rate of and the uses of the proceeds. By far and away the best use of those proceeds is a cut in payroll taxes to encourage employment. As time goes on and economic conditions improve, Congress could adjust both the carbon tax rate and the payroll tax rate to reflect the improvement and dedicate the resulting revenue toward deficit reduction. That would be a far better strategy for encouraging jobs than any debt financed, or income tax financed, targeted jobs bill now under consideration. Thank you.