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Large Tax Cuts are Needed to Prevent a Hard Landing

L. Randall Wray *(info)*

What a difference thirty days can make! Just a month ago, most economists still fretted over the "overheated" economy and inflation pressures. Candidate Al Gore promised rising budget surpluses that would be safeguarded in "lock boxes". Fed officials were unsure that they had raised interest rates sufficiently to slow "unsustainable" growth. And while stock prices had stagnated—especially those listed with Nasdaq—most observers still believed that the "New Economy" was a real *phenom* that would banish recessions to the dustbin of history. Now new President Bush advocates a $1.3 trillion dollar tax cut to try to cushion the hard landing that more and more economists are coming to recognize as a distinct possibility. Fed watchers push for interest rate reductions. The New Economy is all but forgotten, and the only question that remains about Nasdaq is whether **every** high tech firm will go bust. Oh for the good old days of early November, 2000.

In this note, I will first examine the causes of this recession. I next turn to an analysis of adjustments that should be made, immediately, to the federal budget to prevent this recession from deteriorating to a hard landing. I believe that the required fiscal adjustment is very large—on the order of at least $450 billion. This means that the budget will be shifted from a surplus of more than 2% of GDP to a deficit of 2.5% of GDP. Note that if this discretionary adjustment is not made, the budget will automatically move to deficit as economic growth turns negative, as household income falls, and as unemployment explodes to double digits—because tax revenues will automatically fall and spending on unemployment compensation and other social programs ("welfare", crime, food stamps) rises. Indeed, if Japan's recession is any indication (and our present situation looks eerily similar to that of Japan at the end of the 1980s), the cyclical budget deficit could reach 10% of GDP if nothing is done soon to halt the downturn. In a sense, we can now choose to immediately (and discretionarily) move the budget to a deficit of perhaps 2.5% and thereby prevent a hard landing that might otherwise generate a much larger deficit along with a long period of stagnation.

Evidence

This slowdown is probably the sharpest in living memory. Growth of real GDP fell from 5.6% in the second quarter of 2000 to 2.2% in the third quarter. Nominal GDP growth similarly fell by more than half—from 8.2% to just 3.8% over the same quarters. Personal income actually fell in October, while purchases of durable goods fell by 2.2% in October. Real nonresidential fixed investment fell by nearly half

between the second and third quarters. Retail sales growth is down, and undesired inventories are rising rapidly. The speed of the slowdown has, if anything, picked up over the fourth quarter. Industrial production fell by 0.2% in November, while manufacturing output fell 0.5%. Excluding energy output (boosted by cold weather), output of consumer goods (durable and nondurable) is down significantly. Industrial capacity utilization fell to 81.6% in November, half a percentage point below its long-term (1967-99) average. Every day another handful of top corporations announces that earnings will fall short of expectations. Auto sales are weak, and layoffs are growing throughout the auto industry. A recent survey of purchasing managers indicated the fourth straight monthly decline. Heavily indebted telecom firms are slashing investment. The S&P recently hit a 52 week low, and NASDAQ is down by nearly half since September 1. California's largest utility companies are in such terrible financial shape that it took an intervention by Energy Secretary Bill Richardson to force generators to sell electricity to them. There seems to be no end to the avalanche of bad news.

Causes

What are the major causes of the recession? Many commentators attribute the downturn to the Fed's rate hikes. These, in turn, were believed to be necessitated by the "unsustainable" nature of the boom, which was said to be so robust that it would cause inflation. While I agree that the boom was unsustainable, I view the unsustainability in a much different light. The problem was not inflation, but rather the unsustainable processes long analyzed by Wynne Godley (see Godley 1999). For our purposes, there are three main factors that generated the slowdown. First, growing government surpluses have reduced private sector disposable income and wealth. Government surpluses, in turn, were driven by the obsession with achieving a government budget balance, which once achieved generated an even more bizarre obsession with eliminating outstanding government debt (which, by definition, is net nominal wealth of the private sector). Second, the US trade deficit similarly reduces American income and wealth. Our trade deficit results from a number of complex processes, however, it could be reasonably argued that tight fiscal and monetary policy in the US have helped to keep the dollar strong and our trade balance negative. Finally, these first two considerations necessarily imply that economic growth could take place only as the private sector spent in excess of its income, financed by an ever-growing mountain of debt.

Indeed, the government surplus means, by accounting identity, that the private sector must reduce its net (or "outside") domestic nominal wealth by surrendering its holding of government bonds, while the trade deficit implies that the US must reduce its net international wealth holdings. These reductions of net (domestic and international) wealth and disposable income made it impossible for the private sector to continue to spend without at the same time increasing its net indebtedness. As lenders observed this growing indebtedness and rising leverage of prospective net income flows, they began to tighten credit—what some are already beginning to call a "credit crunch". Unfortunately, at the aggregate level this can only make matters worse, because if the private sector cannot increase its borrowing, it will not be able to increase its spending. If economic growth subsides, credit quality will be further eroded-leading to further credit tightening. Hence, the credit crunch and the

spending slowdown are connected in a reinforcing manner. While maintenance of "easy" credit could perhaps postpone the day of reckoning, the unsustainable processes in place make a hard landing virtually inevitable.

The problem, then, was not that growth was too high, but rather that the twin "surpluses" endangered it—the US government budget surplus and the foreign sector surplus (that is, the US trade deficit). Together, these required ever-rising private, domestic, sector deficits that were "unsustainable". Household spending was already slowing during the second quarter, so that growth was primarily driven by high investment. This, however, could not continue for long as falling capacity utilization rates caused firms to rethink their capital needs.

Balance Sheet Implications

The rising budget surpluses meant that government debt held by private investors had to be declining in quantity—from $3.4 trillion in 1997, to 3.175 trillion in 1999, and to just $2.987 trillion by June 2000. Thus, these budget surpluses sucked about half a trillion dollars worth of safe assets out of private portfolios. At the same time, the stock market peaked, raising the value of equities in private, noncorporate (household and nonprofits) portfolios from $5.8 trillion in 1997 to $8.643 trillion by the end of the first quarter of 2000. However, as equity prices fell, by the end of the second quarter, the equities in these portfolios were worth only $7.9985—a loss of over $0.64 trillion. Added to the loss of aggregate wealth due to budget surpluses, we are talking of a loss of well over a trillion dollars of the value of portfolios of private noncorporate investors by June. This does not include losses over the third and fourth quarters. Since September 1, NASDAQ alone has lost half its value. Indeed, the crash of high tech stocks has so far wiped out over $3 trillion of stock market value (obviously, not all of this was in household portfolios—much was in business portfolios, which is no more comforting). It is not surprising that a "hit" of this magnitude might depress private sector spending. Note that this does not take account of the worsening net wealth position of the USA private sector vis-à-vis the rest of the world. Furthermore, as budget surpluses are projected to continue to increase, net wealth positions of the private sector will continue to worsen, even if the stock market falls no further. On current projections, the surpluses increase even if growth falls to 2.5% per year.

Policy Implications

In order to allow the private sector to bring spending more closely in line with its income, the government's budget stance must be changed significantly and immediately. If the household sector (which was responsible for most of the private sector deficits) were to balance its budget in the first quarter of next year, just to hold GDP constant this would require that the federal budget make a move of perhaps 6% of GDP, from surpluses of more than 2 percent of GDP to deficits of 4 percent of GDP. As the economy continues to slow, it is possible that the trade deficit will fall due to reduction of household purchases of imports. Further, slower growth will reduce the size of state and local government surpluses (by lowering tax receipts and increasing social spending) that are draining private sector income. Thus, it is likely that the private sector's deficits will be reduced automatically as imports fall and

state and local government surpluses fall. If this does occur, the size of the fiscal adjustment required would be smaller than 6%, meaning that a federal budget deficit somewhat smaller than 4 percent of GDP might stabilize GDP. Offsetting this, however, is the probability that a substantial portion of tax cuts will be "saved" or used to retire debt, implying a larger tax cut will be required to produce the necessary stimulus. For the purposes of our analysis, I will presume that the Federal government should aim for a deficit of 2.5% of GDP for next year. If growth still turns negative, the federal budget deficit target should be increased.

President Bush has proposed tax cuts totaling $1.3 trillion over the next several years. Precise details have not been forthcoming, but discussion during the campaign leads me to believe that when a concrete proposal is made, most of the cuts would come in the future, with only small cuts proposed for next year—perhaps only $150 billion, which would still leave a budget surplus of more than half a percent of GDP. In order to get to the required deficit of 2.5% of GDP, tax cuts of another $300 billion would be required. What kinds of tax cuts would give the "biggest bang for the buck"?

a. Payroll Taxes

Most of the federal budget surplus can be attributed to the huge surpluses run up by Social Security—about 90% of the surpluses achieved to date are "off-budget", and most of that is in the Social Security program. Over the past two years there has been a great deal of discussion about these surpluses, said to be "accumulated" in the Social Security Trust Fund. However, it is now widely recognized that the Trust Fund is nothing more than an accounting fiction. It is also widely recognized that this fictional Trust Fund cannot do anything to help provide for retiring babyboomers in the future. Most observers recognize that there is no way to "lock away" payroll tax receipts for future use. Nor does elimination of the Trust Fund entail any financial risk to the government's ability to pay Social Security benefits in the future as they come due. Indeed, the government's ability to pay these benefits is not dependent on tax revenue at all. Hence, there is no reason to try to preserve budget surpluses in the Social Security program. (All these matters are discussed in more detail in Bell and Wray 2000.)

Indeed, there are very good reasons to cut payroll taxes. Economists have long recognized that payroll taxes are regressive; indeed, for most lower income households, the payroll tax is much more burdensome than is the income tax. Further, the payroll tax is specifically levied on working, providing a powerful disincentive to employment. Not only does it raise the costs to every employer of creating new jobs, it also discourages people from working. Payroll taxes make American labor more expensive, discouraging investors from locating plant and equipment in the US (thus, contributing to the trade deficit). Payroll taxes are inflationary because they increase the costs of production. They distort the market mechanism, by raising the costs of labor relative to the costs of capital. For these reasons, much of the additional $300 billion tax cut should be targeted to the payroll tax. Furthermore, a cut of the payroll tax is simple to administer and easy to understand, it has an immediate impact (increasing take-home pay from the moment it is implemented), and it benefits workers of all types as well as businesses.

There is an additional, important consideration. Since the primary goal of the tax cut is to raise private demand for our nation's output, the ideal tax cut should put more disposable income into the hands of families that will increase consumption (and, possibly, spending on residential and nonresidential investment). It is generally accepted by economists that the household propensity to consume varies inversely with income, thus, a tax cut that favors lower income households should have a larger impact on consumption than would a tax cut that favors high income households.

How large should the payroll tax cut be? To return the OASDI portion (the "retirement" and disability insurance part) of the Social Security program to balance, a payroll tax cut of something more than $150 billion would be required. If we allocate the entire, required, $300 billion tax cut to OASDI, the program would run an accounting deficit of about $150 billion. I emphasize that an accounting deficit has no impact on the government's ability to pay Social Security benefits, now or in the future.

b. President-elect Bush's proposal

Note that this tax cut is in addition to President Bush's likely proposal (which will cut marginal income tax rates), and is consistent with the desired characteristics of a tax cut as stated by Bush during his campaign. His campaign platform argued that he favors a tax cut that would:

i. **Trust People:** Governor Bush believes all taxpayers should be allowed to keep more of their own money.

ii. **Lower the Record-High Tax Burden:** Federal taxes are the highest they have ever been during peacetime: Americans work more than four months a year on average to fund government at all levels.

iii. **Cut Marginal Rates:** As President Reagan demonstrated, the best way to encourage economic growth is to cut marginal tax rates across all tax brackets.

iv. **Increase Access to the Middle Class:** Under current tax law, low-income workers often pay the highest marginal rates. For example, a single waitress supporting two children on an income of $22,000 faces a higher marginal tax rate than a lawyer making $220,000.

A payroll tax cut accomplishes all these results. A payroll tax cut will generate significant tax relief for low income earners struggling to reach the middle class. It provides a powerful incentive to work harder, generating economic growth. And it will spur consumption spending by increasing disposable income of those with a high propensity to consume.

c. Additional Tax Relief

I recognize that even if most observers have come to recognize that keeping separate accounts for Social Security is just an accounting gimmick, it may not be politically feasible to pass a $300 billion tax cut that would generate deficits in the OASDI program. This is because Social Security has long been analyzed as if its budget were separate from the rest of the federal budget. Hence, it may be more politically feasible to advocate a payroll tax cut that would return Social Security to "pay as you go"—in other words, to a balanced budget. As discussed above, this would allocate approximately half of the $300 billion tax cut to the Social Security program. This means that another $150 billion tax cut will be required. In keeping with the discussion above, these cuts should be designed to increase spending, to relieve debt burdens, and to distribute most of the cuts to working households. This could be accomplished, for example, through increases to the earned income tax credit. This would target the tax cut to the lowest income households, significantly increasing the rewards to working. In addition, tax credits for educational expenses might make college more affordable, and is in keeping with President Bush's priorities. Finally, tax credits for child care would help working families. I would also favor substantial spending increases for education, public infrastructure, childcare, and health care for those with inadequate coverage. However, it may be more difficult politically to pass spending initiatives, and the lag time involved in boosting aggregate demand might be larger than that for a tax cut.

Conclusion

There is already substantial evidence that the economy is moving toward a hard landing. The federal budget has become so biased toward surplus that automatic stabilizers cannot be counted upon to cushion the downturn. Furthermore, as I have long suspected, the first reaction of economists and policymakers has been to turn to the Fed to ask for interest rate reductions. In order for monetary policy to prevent a recession, the lower rates would have to stimulate private sector borrowing. However, as I have argued, the private sector had been fueling the Clinton boom by unsustainable deficits—indeed, as soon as the private sector stopped increasing its borrowing, the boom was doomed. It thus is a bizarre policy recommendation to suggest that the Fed ought to try to induce the private sector to re-embark on a fundamentally unsustainable borrowing frenzy as a solution! Rather, it makes much more sense to look to the underlying cause: the extremely tight fiscal policy that has been sucking private income and wealth from the economy. Hence, the solution is to rectify the fiscal imbalance.

In summary, an immediate tax cut of approximately $450 billion will be required over the next year. President Bush may come forward with a plan that would cut taxes by as much as $150 billion. I recommend another $150 billion tax cut through reduction of the payroll tax. Finally, another $150 billion tax cut would increase the earned income tax credit, provide tax credits for educational spending and child care, or provide other similar tax credits. ◆

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