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WHAT SHOULD THE FEDERAL GOVERNMENT DO TO AVOID A RECESSION?

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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JOINT ECONOMIC COMMITTEE

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WEDNESDAY, JANUARY 16, 2008

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met at 9:30 a.m. in room SH–216 of the Hart Senate Office Building, the Honorable Charles E. Schumer (Chairman of the Committee) presiding.

Senators present: Kennedy and Bennett.

Representatives present: Maloney, Hinchey, Hill, Cummings, Saxton, English, and Brady.

Staff present: Christina Baumgardner, Heather Boushey, Nate Brustein, Stephanie Dreyer, Connie Foster, Chris Frenze, Tamara Fucile, Nan Gibson, Colleen Healy, Israel Klein, Michael Laskawy, and Jeff Wrase.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER, CHAIRMAN, A U.S. SENATOR FROM NEW YORK

Senator Schumer. OK, good morning, everybody. Thank you all for coming, and welcome to the first hearing of the new year of the Joint Economic Committee.

It's also the first Congressional hearing in 2008 to examine the most effective ways to stimulate the U.S. economy, which is teetering on the brink of recession.

We're lucky to have such a distinguished panel, who I will introduce in a few minutes, but I just want to say a special thank you to Larry Summers, my friend and a former Treasury Secretary.

His willingness to make time here today and think about these difficult issues during the course of his career, make this Committee, the Congress, and the American people, much better informed.

I also want to thank the JEC's Vice Chair, Congresswoman Maloney, from my home State, our Ranking Republican, Jim Saxton, and Senator Ted Kennedy, who is the longest-serving Member of this panel.

Now, economists—from former Federal Reserve Chairman, Alan Greenspan, to New York Times columnist, Paul Krugman—are suggesting that we're either in a recession already, or on the brink of recession.

The discussion of economic stimulus is no longer an academic exercise. In fact, real economic stimulus measures, enacted quickly, could be the last thing between us and a deep or protracted recession.

The December turndown in retail sales and new concerns that auto loans and credit card payments could follow the pattern of mortgage payments and head south, makes quick action on a stimulus package all the more necessary.

Even the current Fed Chairman, Ben Bernanke, said last week that the economic outlook for 2008 had worsened, and he listed all of the various forces dragging down the economy.

On Monday, I called Chairman Bernanke personally to get his thoughts on the economy, and he said that fiscal stimulus is certainly needed, and that he would be generally supportive of the Congress and the President enacting such a stimulus.

He said that while he wasn't going to endorse a specific plan, if an economic stimulus package was properly designed and enacted so that it enters the economy quickly, it could have a very positive effect on the economy.

He said that monetary policy, which is obviously important, should be augmented by a stimulus package.

In some ways, much of the bad news that we're faced with now could have been averted. Last year, with the subprime mortgage crisis staring us in the face, the Bush administration was unwilling to act to stem that crisis, and refused to consider the possibility that a recession was on the horizon.

As many economists predicted, the subprime mortgage meltdown spilled over into the broader housing market, damaged credit markets, and brought us to the precipice of recession.

Because of Presidential inaction to mitigate the effect of the subprime mortgage meltdown, the economy is now on the edge of recession.

This Nation desperately needs a strong stimulus package. There are six key points informing our actions as Democrats as we move forward on a stimulus package:

First, we want to work with the President to get something done quickly that will help the economy and middle class American families.

There was much partisanship in last year's Congress, but the state of the economy makes it imperative that we put partisanship aside and enact a stimulus package.

Speaker Pelosi and Majority Leader Reid sent a letter to the President saying they want to work with the White House and Republicans in Congress to achieve a stimulus package, and next week's meeting is a good first step toward achieving that goal.

We are prepared and willing to work with President Bush and our Republican colleagues in Congress to craft a bipartisan, balanced, economic stimulus package.

Second, we must enact a stimulus package that is timely, targeted, and temporary. Economists across the ideological spectrum agree that to deliver effective stimuli, the Federal Government needs to act with those principles in mind.

It should be targeted at the middle class, who will bear the brunt of the economic decline, and who, with dollars in their pockets, will provide a stimulus to the economy that is much needed.

It should be timely because we can't introduce policies that won't kick in until long after a recession is already upon us.

It should be temporary because we don't want to enact stimulus policies today that permanently burden our children tomorrow.

Third, to be effective, these proposals need to include a combination of both tax cuts and spending stimuli. Direct injections of cash into the economy through both immediate consumer and government spending are the shots in the arm needed to ward off a recession.

In fact, many economists believe that spending stimuli have a greater immediate effect on the economy than tax cuts, because the former guarantee that the dollars authorized will be spent, while the latter do not.

Both tax cuts and stimulus spending cash infusions are important because they support otherwise declining demand that stems from rising unemployment and falling household incomes. Monetary policy alone cannot address those necessary goals.

An effective stimulus package that includes both expenditures and tax cuts in combination with monetary policy is the best way to avoid a recession.

Fourth, as we create a stimulus package, we must jettison ideological baggage on both sides. The last thing the economy needs right now is inaction while the parties fight old and ongoing battles.

Renewing the Bush tax cuts, which don't expire until the end of 2010, should be off the table because they will thwart any chance of passing a stimulus package.

They are not timely, they are not targeted, and they are not temporary. Some congressional Republicans may be planning to add these tax cuts to the stimulus package, or even make them the centerpiece of the package.

The President should and must resist attempts to include making his tax cuts permanent part of the package, especially in the Senate, because they will impede or even kill such a package.

Fifth, on the question of PAYGO, I believe there is a growing consensus, not unanimous, in the Democratic Caucus, that paying for the stimulus now would take away from the economic boost we're seeking to create. The stimulus, by definition, must have a net of spending over income.

Sixth and last, the Administration needs to focus on the housing crisis and declining home values. The housing crisis has been the epicenter of this potential recession, and the President's hands-off approach to the housing crisis, clearly has not worked.

Fortunately, because of the important work of economists across the ideological spectrum, and, most recently, by the nonpartisan Congressional Budget Office, we know what works and what doesn't work when it comes to economic stimulus.

We know that extending unemployment insurance is one of the most effective stimulus proposals, because we have deployed it successfully in the past, and it gets lots of bang for the buck.

Lump-sum payments to households in the form of tax rebates or tax holidays are also very effective.

On the other hand, we know from experience that long-term top relief for the very top on the economic spectrum, is not a successful stimulus.

So, some of the important stimulus measures we're considering include the broad-based tax rebates, extending unemployment insurance and food stamps, targeted business tax cuts to stimulate job creation, and Federal assistance to the States.

In conclusion, it is long past time to scrap the old Bush economic playbook of tax cuts for the wealthy as the only economic policy, and replace it with a balanced strategy that lifts the economic fortunes of all American families.

I hope that this hearing today and subsequent conversations with my colleagues and the Administration, will get us to a bipartisan package the American people deserve as quickly as possible.

Now, given the fact that Dr. Summers needs to leave by 11, I'm going to limit opening statements, in addition to myself, to Congresswoman Maloney and Congressman Saxton, and I would like to extend this courtesy to Senator Kennedy because he is Chairman of the Senate Health, Education and Labor Committee. He's the longest-standing Member of this Committee and he will play a critical role in his Committee in crafting the economic package.

I invite other Members to submit statements to be included in the official record.

Congresswoman Maloney.

[The prepared statement of the Senator Charles E. Schumer appears in the Submissions for the Record on page 34.]

Representative Maloney. Thank you. I'd like to thank the senior Senator——

Senator Schumer. Oh, I'm sorry. Congressman Saxton is next.

Representative Saxton. Please go ahead.

Representative Maloney. No, I defer.

Senator Schumer. Congressman Saxton, I apologize.

OPENING STATEMENT OF HON. JIM SAXTON, RANKING MINORITY, A U.S. REPRESENTATIVE FROM NEW JERSEY

Representative Saxton. Thank you very much. I am pleased to join in welcoming the witnesses this morning. Thank you, each of you, for being here.

This is a very important hearing. It's important not only to those of us in this room, but it's extremely important to the American people, all of whom, of course, take part in our economy.

The recent slowdown in the economy is a serious concern to the public and to all of us as policymakers, alike.

According to standard measures of performance, such as economic growth and the unemployment rate, the U.S. economy appeared to be doing quite well through the third quarter of 2007.

However, more recent data indicate that the pace of economic growth slowed sharply in the final quarter of the year. Recent economic data makes clear that there are a number of challenges facing us in the economy.

Residential investment declined at a 20 percent rate in the third quarter, continuing a longer trend. Housing prices are falling in many areas of the country, as housing inventory levels rise. Oil prices are near $100 a barrel and the dollar is falling.

Since last summer, it has become clear that a number of large financial institutions have invested in mortgage securities of dubious quality. Huge writedowns of assets by Citicorp and Merrill

Lynch highlight serious concerns about the value of mortgage-backed securities.

Uncertainty about the extent of bad investments related to subprime and other mortgages has spread, resulting in sharp declines in the valuation of bank stocks.

Financial markets have become very volatile. The Fed has acted by reducing interest rates and developing new ways to inject funds into the banking system.

As a CBO report released yesterday noted, the Federal Government also has in place automatic fiscal stabilizers that have boosted the economy in past recessions, quite substantially. Unemployment insurance, for example, and various other programs which have been important in past slowdowns have boosted GDP by the equivalent of up to $350 billion during those downturns, according to the CBO report.

The actions of a powerful central bank and these automatic stabilizers ensure that a policy response to any severe slowdown is already in place.

Although most economists view Federal Reserve monetary policy as the best means to stabilize the economy, additional steps may be considered.

In considering its options, the first thing Congress should do is to make sure that such actions do not further damage the economy. For example, policymakers should resist the temptation to use targeting as a rationalization for channeling resources into earmarks at the behest of special interest groups or others. How all of this new spending can be reconciled with the Majority's PAYGO rules is rather unclear at this point.

Furthermore, as the CBO report notes, infrastructure projects are not appropriate components of economic stimulus legislation, because these appropriations will not be expended quickly, but will be drawn down over time.

There is real risk that a stimulus package will morph into a special interest Christmas tree. As The Congress Daily headline said yesterday, "K Street Lines Up for Slices of the Stimulus Pie" This must be avoided.

With politicians designing the economic stimulus package, a positive impact on the economy is far from guaranteed, and so I look forward to these discussions.

I guess I would just like to add one final note: I agree with much of what my friend, Senator Schumer, said.

Our one area of disagreement, is this: Because the private sector drives our economy and because business people and investors are currently making plans for their economic activities over the next couple of years, it seems to me that to send the message that we are automatically going to reject the notion of continuing the tax cuts that are currently in place past 2010, given expectations on the part of people who are making plans for their investments today, would be a very bad mistake. Thank you very much.

[The prepared statement of Representative Jim Saxton appears in the Submissions for the Record on page 37.]

Senator Schumer. Thank you, Congressman Saxton.

Congresswoman Maloney, our Vice Chair.

OPENING STATEMENT OF HON. CAROLYN B. MALONEY, VICE CHAIR, A U.S. REPRESENTATIVE FROM NEW YORK

Representative Maloney. Thank you very much. I'd like to thank the Senior Senator from New York, Senator Schumer, and Senator Kennedy, for their long-term leadership on the economy, and all of our distinguished panelists.

Since some of you are under a time constraint, I would like unanimous consent to put my opening statement in the record, so that we can move forward.

Dr. Summers has said that any stimulus should be targeted, timely, and temporary, and I'd like to hear from all of the panelists on what four actions they would take to stimulate our economy? I am hopeful that the President and Congress can move forward swiftly with a stimulus package, and I'd like to know also, what impact this would have on the long-term competitiveness of our country.

So I yield back my time and place my opening statement in the record.

[The prepared statement of the Representative Carolyn B. Maloney appears in the Submissions for the Record on page 38.]

Senator Schumer. Thank you, Congresswoman Maloney.

Senator Kennedy.

OPENING STATEMENT OF HON. EDWARD M. KENNEDY, A U.S. SENATOR FROM MASSACHUSETTS

Senator Kennedy. Thank you, Mr. Chairman. I want to commend Senator Schumer for holding these important hearings. There are a lot of important things that are happening in the country today, but I think this hearing has to be right up there with all of them, because its implications, in terms of the future of our economy, are so profound.

I join in welcoming Larry Summers, an old friend, a distinguished public servant, one of the Nation's preeminent economists. Larry Mishel, who I have enjoyed working with for many years, welcome; William Beach, from the Heritage Foundation, I look forward to your testimony, as well.

Americans are increasingly anxious about making ends meet. Many economists say a recession is coming and that it may be severe. For millions of families, the recession is already here.

They're seeing their jobs disappear, their savings gone, their homes at risk—their costs are going up week after week and month after month.

We're committed to action to stabilize the economy and relieve the distress that families are facing. We'll work with President Bush, our colleagues on both sides of the aisle in Congress, to pass an effective stimulus package, but we've got to adhere to some core principles.

First, anything that we do, should be quick and temporary. We need to get money into workers' pockets in 2008, to encourage spending to boost the economy.

What we don't need, are long-term tax cuts that will drag our economy down in future years.

Second, our plan should be focused on average Americans facing tough times. Ninety percent of the benefit of any stimulus package should go to 90 percent of ordinary Americans who work for a living, depend on a paycheck, and struggle to pay their bills. They are the ones who will make our economy start growing the fastest again.

Third, we need a robust package of reforms. We can't just tinker at the margins. Americans need real help that will make a real difference in their lives, and they need it as soon as possible.

That means additional unemployment benefits to help workers pay their bills while they look for new jobs. It means transitional health coverage, so that workers don't lose insurance if they lose their jobs.

It means assistance to States that are forced to cut budgets for critical necessities like Medicaid.

It means emergency heating assistance for families swamped by soaring costs of energy.

And it also means emergency job training to help workers quickly gain the skills they need for new jobs.

In my State, 76,000 jobs are out there looking for workers. There are 24 applicants for every slot for training. People are out there; they want to get the skills; they want to go to work; they can, and we ought to give them the help they need.

We must increase food stamps so that low-income workers can feed their families.

Last, but far from least, we should consider the immediate tax rebate for low- and middle-income families. A rebate makes sense as another effective way to help jump-start the economy.

We must be careful to reject any attempt to use the current crisis as a pretext for permanent new tax breaks for wealthy or corporate America.

In all these efforts, we must be guided by a simple principle: People do not work for the economy; the economy should work for the people.

If we want an economic recovery that works, if we want real opportunity and sustainable growth, that effort starts and ends with working families.

Our economy is at a crossroads. We must act carefully to choose the right path for the future. It's time to rebuild an economy that puts working families first.

I'm confident we can do it; I'm certain that we must do it. We owe the American people our best efforts, and I look forward to working with my colleagues on both sides of the aisle to put our economy back on track. Thank you, Mr. Chairman.

[The prepared statement of Senator Edward M. Kennedy appears in the Submissions for the Record on page 40.]

Senator Schumer. Thank you, Mr. Chairman, and I want to welcome Senator Bennett here, as well. He doesn't wish to make an opening statement, but we'll ask for unanimous consent that his statement be entered into the record next, and all other statements will be entered into the record.*

Senator Schumer. It is now my honor to introduce our witnesses. We first have Dr. Larry Summers, who is the Charles Eliot University professor at Harvard University, the 27th president of

*Senator Bennett's statement was unavailable at time of publication.

Harvard University, an eminent scholar, and an admired public servant.

He's taught on the faculty of Harvard and MIT, served in a series of senior public policy positions, including as Domestic Policy Economist for the President's Council of Economic Advisers; chief economist of the World Bank, and, of course, Secretary of the Treasury of the United States.

In 1993, he received the John Bates Clark Medal, given every 2 years to the outstanding American economist under the age of 40. Could you still get that?

[Laughter.]

Senator Schumer. Next, Dr. Lawrence Mishel who came to the Economic Policy Institute in 1987 as EPI's first research director, then as vice president and now president. He played a significant role in building EPI's research capabilities and reputations.

He's researched, written, and spoken widely on the economy and economic policy as it affects middle- and low-income families. Dr. Mishel received his B.S. from the Pennsylvania State University; his M.A. in economics from American University; and his Ph.D. in economics from the University of Wisconsin.

Mr. William Beach is director of the Center for Data Analysis at the Heritage Foundation. In that role, he is the think tank's chief number-cruncher. He oversees Heritage's original statistical research on taxes, Social Security, crime, education, trade, and a host of other issues.

Prior to joining Heritage, Mr. Beach held a variety of posts in the public and private sectors. He's a graduate of Washburn University in Topeka, Kansas, holds a Master's Degree in history and economics from the University of Missouri at Columbia, and is a visiting fellow at the University of Buckingham in Great Britain.

Dr. Summers, you may proceed. The entire statements of all three of you will be read into the record and you may all proceed. We'll try to limit the statements to around 5 minutes. If you need a little more, take it.

STATEMENT OF DR. LAWRENCE SUMMERS, FORMER U.S. TREASURY SECRETARY; CAMBRIDGE, MA

Dr. Summers. Thank you, Mr. Chairman, for the opportunity to testify before this Committee.

This Committee has its roots in a post-World War II recognition that Government can act strongly to tame the business cycle and respond to the threat of recession, and so it is perhaps fitting that your first hearing this year address the concern of managing demand in our economy so as to avoid recession.

I want to ask and to try to answer six questions bearing on our current economic situation and the prospects for fiscal stimulus: First, is fiscal stimulus desirable at present? Yes.

There was considerable debate a month ago about the prospects of recession, and I would say some of us who felt a recession was likely held a strong minority position. Unfortunately, in the last month, the data stream has virtually all been negative, with a very weak employment report, very unfavorable retail sales, and reports from major financial institutions in the last couple of days that suggest growing problems in the consumer sector and consumer credit.

At this point, I think the preponderance of probability is on a U.S. recession this year. There is the possibility, though not yet the probability, that a recession could prove long and severe, if a vicious cycle occurs in which credit problems cause economic problems, which cause further credit problems, which in turn exacerbate the economic problems.

Over the next 2 years, the difference between economic performance with and without fiscal stimulus is likely to be several hundred thousand jobs and a loss in the range of one thousand dollars for the average family.

If fiscal stimulus is successful in preempting a severe recession that would otherwise occur, the gains would be far larger.

A second question: Why not rely on monetary policy to stimulate the economy and focus fiscal policy on longer-term issues?

As Chairman Bernanke has certainly recognized, monetary policy has an essential role to play in maintaining demand and growth and in combatting financial instability.

However, fiscal policy also has a critical role to play for a variety of reasons: Fiscal policy is faster and surer, especially in the presence of the kind of financial problems that we have today.

Second, proper fiscal policies can target the innocent victims of recession and directly promote job creation.

Third, full reliance on monetary policy is problematic in an environment where excessively low interest rates would put the dollar at risk, could lead to excessive increases in commodity prices, and could, as we've seen, exacerbate the problems of asset bubbles and moral hazard that contribute to the difficulties that brought us to this point.

In a situation of such uncertainty, a diversified approach to stimulus is best.

This question: How great is the risk of overheating the economy and causing inflation? Should we wait further for definitive evidence of recession?

In my judgment, the balance of risks is now unambiguously on the side of recession and slowdown.

Inflation over the least year, measured exclusive of the transient factors of food and energy, was 1.9 percent. Thanks to the introduction of indexed bonds during the 1990s, we now have a market measure of inflation expectations and can look at the difference between nominal bonds and indexed bonds to gauge inflation expectations.

They are low today, relative to where they have been over the last 2 years.

Any of us who have talked to workers or to business, sense that this is an environment where people are scared, not an environment where they are pushing to create the kind of wage-price spiral that has given rise to inflation in the past.

Economic cooling is a much greater risk today than economic overheating. There is sufficient weakness in the economy now to justify stimulus legislation that will take effect as rapidly as possible.

Fourth, how large should a stimulus package be? I have previously advocated a stimulus in the range of $50 to $75 billion. Given recent data, I now believe that it would be appropriate to enact a program of this magnitude, as soon as possible, while at the same time making provision, perhaps with a contingent trigger, for a second tranche of similar magnitude if the economic data continue to prove negative, as I expect they will.

A program of $50 to $75 billion would represent between a third and a half of a percent of GNP, and would run very little danger of overheating the economy.

If delivered in the second and third quarters of 2008, this program could have a material impact on consumers and on confidence, more generally. A larger program might be problematic, particularly if it contains measures that would have impact only with a delay.

However, because policy has been behind the curve for some months now, it would be appropriate to design a program in which further stimulus could take effect without the need for additional legislative debate and action if the economic situation deteriorated even more.

The two-tranche approach could involve a trigger based on payroll employment numbers, or, alternatively, a discretionary trigger based on how the Secretary of the Treasury or another Government official reads the economic statistics.

Five: What should be contained in a stimulus package? Mr. Chairman, you were kind enough to repeat my mantra on this topic. It should be timely, targeted, and temporary.

In my judgment—and here, very similar judgments have been issued by the Congressional Budget Office—measures that are most likely to fulfil these criteria include: Across-the-board tax rebates that go to all consumers; adjustments in withholding schedules that benefit all taxpayers to an equal extent; increases in unemployment insurance benefits; and increases in food stamps.

To echo a judgment that you reached, in my judgment, announcements today of future tax reductions—taking effect several years hence—would have a negative impact because of their effect on projected future budget deficits that would dwarf any positive incentive impacts that they have on investment incentives. Therefore, they should be avoided.

The question of business incentives naturally arises. My reading of the evidence suggests that the case for business incentives is not compelling. The principal inhibitor of business investment is lack of market demand, not the cost of capital, and the experience with the 2001 stimulus program is not terribly encouraging.

On the other hand, there is a reasonable argument that temporary investment tax credits or accelerated depreciation schemes, might pull some investment forward into 2008 and thereby, provide stimulus.

Though the cost of a business incentive program is not terribly compelling, if one is enacted, it should be incremental and apply only to investment above some benchmark, such as two-thirds of the previous year's investment or depreciation. This would assure all the benefits in terms of encouraging the scheduling of investments forward, at only a small fraction of the revenue cost, and permit a greater fraction of resources to be targeted to those households that have been most hurt by recession.

On the spending side, the measures most likely to be effective are temporary increases in benefits, perhaps for the long-term unemployed and food stamp recipients.

I would stress, in general, that the more detailed the efforts to achieve specific programmatic objectives, whether on the tax side or the spending side, the greater the risk of delays.

A high burden of proof should be placed on any newly designed program proposed as a stimulus measure, to demonstrate that it can have rapid impact.

Should stimulus be paid for within a given budget window? As you noted, Mr. Chairman, any program in which stimulus was paid for contemporaneously would vitiate itself because the withdrawals from the economy would equal the injections.

The more difficult question is, what about paying for stimulus over a 5 or a 10-year window? Here there is some economic support because it would reduce any adverse impact on capital costs and avoid the resulting increase in interest rates.

On the other hand, the need for offsets would likely lead to substantially more protracted discussion and debate over a stimulus program, which could compromise its ability to be enacted on a timely basis.

In my judgment, it would not be irresponsible to enact stimulus without offsets, as long as the stimulus program that was enacted was unambiguously timely, targeted, and, most important in this regard, temporary.

Mr. Chairman, in conclusion, any economic policy judgment is a matter of balancing risks. The risks of doing too little, too slowly, with respect to the recession forces that are gathering, are far greater than any risk that the political process will do too much, too rapidly.

I urge the Congress to take prompt action.

[The prepared statement of Dr. Lawrence Summers appears in the Submissions for the Record on page 42.]

Senator Schumer. Thank you, Dr. Summers.

Dr. Mishel.

STATEMENT OF DR. LAWRENCE MISHEL, PRESIDENT, ECONOMIC POLICY INSTITUTE; WASHINGTON, DC

Dr. Mishel. Thank you very much, Mr. Chairman and Members of the Committee. I want to thank you for the opportunity to explain why the U.S. economy needs a large economic stimulus to boost demand for goods and services and to prevent a serious and protracted loss of jobs, rising unemployment and income loss.

My testimony makes three key points: First, the economy, and especially the labor market, is in serious trouble and immediate intervention of sufficient size is needed to prevent a vicious cycle of job loss and reduced demand.

And, most importantly, we are—I think all forecasters see rising unemployment this year and next.

We project that if the unemployment rate rises as much as Goldman Sachs has projected it will, then the typical middle class family will lose $2,400 over this year and next. That is something we need to try to ameliorate.

Second, the right stimulus needs the biggest bang for the buck. The idea of timely, targeted, temporary, I endorse. We think increasing unemployment compensation, providing State fiscal relief, and issuing targeted tax rebates, fits this.

Third, we also believe that targeting spending toward infrastructure repairs, not our grandfather's public works programs, but repairs, can be done quickly and efficiently and put more than a million people to work.

In terms of the timeliness of this, the concern with what I'm urging, is that we focus on unemployment. Unemployment is going to be high this year. It will be high next year.

If there are infrastructure repair programs that are begun this spring and actually carry over into early 2009, that's just fine. Unemployment is expected to be over 6 percent in 2009.

Mr. Chairman, the economy has been broken for some time. We are in the last stages, probably, of the first economic recovery where the typical middle class family will have achieved less income than they had at the beginning of the business cycle, in this case in 2000 or 2001.

We're not here to talk about all the ways the economy is broken, but to prevent the further damage of rising unemployment and the income losses that families will face.

Let me return to this first big point about unemployment. You can either believe there's a recession, the economy is going to contract—and job growth will contract—and there will be a sharp rise in unemployment, or you can believe—as I think my friend Bill Beach here believes—that we're going to have very slow growth, very modest job growth, and rising unemployment this year and next.

The key issue is, there's going to be rising unemployment. Don't focus totally on GDP, the way that brokerage house economists might. What American working families need are jobs to ameliorate the impact of the higher unemployment.

As I said, Goldman Sachs and others are projecting that even by the end of this year we will see an unemployment rate of 6.2 percent, and this will put downward pressure on wages and income.

If we don't see bold action, we're going to end up with the same kind of lousy recovery we did at the beginning of this decade where even after the economy so called was recovering, we had 2 years of further job losses and rising unemployment. We can't afford to do that again.

I want to point out that my Institute, along with some other organizations—the National Employment Law Project, the Coalition on Human Needs, National Women's Law Center, the AFL–CIO, and others—have written a letter to the Congressional leadership, urging some changes in the unemployment insurance system; that I would like to enter into the record.

[The letter referenced appears in the Submissions for the Record on page 54.]

Dr. Mishel. I think everyone agrees—it sounds like—that unemployment insurance is very important in a downturn. It gives money to the people who are the most likely to spend it. It has the biggest bang for the buck.

Our system is broken, overall, in the unemployment insurance system. It is definitely broken during recessions when our triggers don't really work to give people the extended benefits, and so we are always too late to do that.

I think it really makes sense to fix this system for all time, to make an automatic stabilizer better, to send some money to those long-term unemployed who will not be able to get benefits under the current system, and to make sure that our unemployment compensation system reaches low-income, part-time workers, and other people that are now excluded from the system.

We also believe that it's important to give fiscal relief to the States, as States who have to balance their budgets in times of recession are forced to raise taxes and cut spending. This only exacerbates a recession.

We can give relief to the States that will prevent them from doing damage to the economy. In the last recession, there was $20 billion of aid to the States; this time, we recommend $30 billion, split equally between a general block grant and an increase in the Medicaid match.

Third, let me turn to infrastructure repairs. At a time when demand by private-sector employers for customers is lacking, it's a really good thing to create public investment that will create jobs and create demand and help break a downward spiral.

Managed wisely, it can be well-targeted and timely, and is definitely temporary if we have a one-time boost for infrastructure repairs, which we believe can be done for bridges, for schools, for water treatment and sewage plants. Anyone reading about the dilapidated state of our school systems or the many, many deficient bridges, should be concerned about this.

We have an incredible backlog, and I think that we can get this money out quickly. For those people who doubt we can get it out quickly, I looked into one particular school system. I picked New York City, just as a random city, and noted that they were given $1 billion to improve school buildings, as part of a court order.

They told us that within 4 months, the entire $1 billion was committed and that it was completed over the next 12 months. I think this experience can be repeated over and over with deficient bridges, water and sewage projects, et cetera.

I talked to the head of the National Governors Association yesterday, and he assured me that, as well.

One word on tax policy: I want to agree that we should have a tax rebate. I think that it is important that it go to all people who pay taxes—payroll taxes or income taxes.

I want to suggest that, as between well targeted and timely tax rebates and infrastructure spending, as you said, Mr. Chairman, all of the infrastructure money is spent. Tax rebates, part of it is spent; part of it is saved.

Part of tax rebates are spent overseas. Almost all of infrastructure repair is spent domestically.

Given the fact that these are spending needs that we have anyway, we get two things out of it: We get to create jobs—boost the economy, and we get a long-term productivity effect, to boot. Thank you very much.

[The prepared statement of Dr. Lawrence Mishel with attachments appears in the Submissions for the Record on page 49.]

Senator Schumer. Thank you, Dr. Mishel.

Mr. Beach.

STATEMENT OF MR. WILLIAM BEACH, DIRECTOR, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION, WASHINGTON, DC

Mr. Beach. Senator Schumer, Congresswoman Maloney, Congressman Saxton, Members of the Committee, I'm very pleased to be here today. You have my bio from Senator Schumer.

There is an increasingly held view that the U.S. economy is slipping into a sustained period of slow economic growth, perhaps even recession. The root of that worsening news is believed to be the collapsing housing sector and the financial institutions and practices that surround residential construction and mortgages.

Further, it is beginning to look as though declines in housing sales, construction, and mortgage credit industries, in general, will continue in 2008, as the mortgage default rate—principally on adjustable-rate mortgages increase.

It is estimated that something above 2 million subprime adjustable-rate mortgages will reset to a higher interest rate in the first few months. The specter of further declines in home prices, more turmoil in credit markets, and the emergence of secondary adverse effects in other part of the economy stemming from these price and credit events, have raised concern about the general economy's near-term outlook.

So, what should Congress do? As I will argue later in this testimony, Congress obviously should do nothing to harm the economy. That's an obvious point, but worth stating.

It should let the Federal Reserve lead the effort to stabilize economic activity, and it should keep its focus on crafting long-term pro-growth economic policy.

Congress should take this moment of slow growth to do what it does best: To set broad economic policy. In this instance, Congress should concentrate on signaling to investors and workers alike, that its principal focus will be on improving pro-growth economic policy, mainly in the areas of tax, regulatory, and spending policy areas.

Serious work by the Congress in these areas will create greater predictability for investors and business owners, and assure workers that they will have a better chance of improving their wages through increased productivity.

How do I see the economy? Larry has basically signalled my testimony, but let me just hit a few points.

While I continue to believe that the U.S. economy's strength and robustness are its principal characteristics now, I, too, have concluded that near-term prospects are poor.

For example, the probability of recession has risen in our models, from 35 to 40 percent, and I could easily see little or zero growth in GDP when the fourth quarter estimates are published.

The decline in residential construction will continue for some time; consumer and investor spending will slow, and growing inventories—principally in the automotive sector—will become a drag on the economy, for inventory buildup in the third quarter actually explains some of the large 4.9 percent growth rate we saw then.

That said, we expect GDP growth in 2008 to remain around 2 percent, and monthly employment growth averaging 75,000 jobs. This is slow growth; this is not recession.

The reason I believe we avoid recession in 2008 is due, in large part, to the substantial contributions to GDP from exports. While domestic demand is expected to grow by a paltry $9/10$ of a percent over the next two quarters, exports are forecasted in our models to expand by 10 percent.

Recent U.S. export growth stems from the lengthening above trend growth in world GDP, largely due to economic strength in Europe and the long-awaited emergence of China and India in the top tier of industrial economies.

What should Congress do, given the slow growth? I'm only going to talk about tax policy. I do, in my written testimony, have mortgage markets regulation and long-term spending, as well, and I direct you to that.

On tax policy, what can we do to decrease risk? Risk is part of the problem here, because investors—the people who drive the economy, that create the jobs, that buy the equipment, that improve the productivity, which causes wages to rise—have seen a signal of increasing taxes.

Among the first things Congress can do to address the current slowdown, is to pronounce definitively, one way or the other on the tax increases scheduled for 2009 and 2011. There are projects, new businesses, and expansion of existing businesses, that would be undertaken today, if Congress signalled that taxes would be lower in 3 years.

Since nearly all major capital undertakings last beyond this 3-year period, it is likely that making all or most of the Bush tax reductions, in some fashion permanent, would stimulate economic activity today, as well as in 2011.

I am probably not the only one here today who knows of businesses that are preparing now for higher taxes in 2011. They are preparing themselves by reducing their riskier projects and providing for stronger cashflows in 2010.

It is altogether possible that there are projects being canceled today, that would otherwise go forward today, if taxes were not scheduled to rise in 2011.

The present speech of policymakers is as important as the policy actions they take. The decisionmakers in business and investment are watching Washington as closely as ever to discern the direction that Congress will take when responding to this crisis.

If that direction includes tax increases, then investors will find more favorable economies to support; and business owners will, as much as they can, locate their expanded activities in places with more favorable tax regimes.

Thus, Congress should signal today what it plans to do on taxes today and in 2 and 3 years. For my part, I urge the Congress to make permanent the key provisions of the 2001 and 2003 tax law changes. Maintaining lower tax rates on labor and capital income will encourage both labor and capital to work harder now when we need that greater activity.

In addition, we know from past experience that accelerating the tax depreciation of capital equipment and buildings, or 1-year expensing of business purchases that otherwise would be depreciated over a longer period of time for tax purposes, can help during periods of slow growth.

This was certainly the record in the last slump.

Demand side stimulus, tax rebates, child tax credit, 10 percent tax record have done little in fact to change the course of sluggish economies, and that record is now fairly complete.

The tax rebates of 2001 did little to stimulate the economy or move it from a prolonged sluggish growth trend. Indeed, the contraction in investment, and thus job creation, did not begin to improve until after the 30 percent partial expensing in the 2002 Act and the 50 percent partial expensing in the 2003 Act, which also cut the tax rates on dividend and capital income.

I am all in favor of temporary tax cuts, especially in this area. If you look at businesses and how they behave when you put in front of them bonus depreciation, especially if it is targeted in industries that have poor job performance, they eat those tax cuts up. There is almost an infinite elasticity on this point.

So I will join with everybody at this table and with what I have heard here in supporting a stimulus package, or in writing about it, that includes the right kind of pro-growth tax policies.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Beach appears in the Submissions for the Record on page 56.]

Senator Schumer. Thank you, Mr. Beach.

I want to thank all of our witnesses for both interesting and, as you can see, divergent testimony. The first question I have is for Dr. Summers:

I would just like you to elaborate. You mentioned, and as you can see from the panel and from some of the discussions here on this side of the table, one of the major issues, I think we can come fairly close to reaching a consensus on what should be, for what kinds of stimuli should be used under the temporary, targeted, and timely rubric.

The biggest problem I see, the biggest hurdle, is what are we going to do about the permanent tax cuts that some think we should enact—as you do, Mr. Beach, and my friend Jim Saxton, and many of us think, both from a policy, but more importantly from an immediate stimulus point of view, don't help.

Now you went a step further, Dr. Summers. You said that they might actually—extending these tax cuts might have a negative impact overall on creating growth in the short term in overcoming recession. Could you just elaborate on that a little bit?

Dr. Summers. Sure, Mr. Chairman. If you imagine that the tax cuts were extended today, what would the effect be? That would not change tax behavior—it would not change the tax law in 2008, or 2009, or 2010. It would only change tax law in 2011, and there would be two principal consequences of that change.

The first, and in my judgment larger, consequence would be an increase in the projected deficit over the subsequent decade and beyond, which would be measured in the multiples of trillions of dollars. This would translate into a projected increase in the magnitude of the National Debt in the trillions of dollars, which in turn would translate into a lower level of national saving and a shortage of capital long after any recession we have now was over.

That would lead to higher capital costs measured in both long-term interest rates equity prices, because of the impact of the expected deficit on the supply and demand for capital and because of the increased risk premiums that would result.

Because markets look forward, the impact would be higher capital costs not just in the future, but today. That would be reflected in every mortgage rate, in every company's stock price. In my judgment, this would be the primary effect.

There is, to be sure, a second effect—which was the one that Mr. Beach emphasizes and the one that Congressman Saxton spoke of. To the extent that businesses contemplating an investment today place substantial value on the tax law as they expect it to prevail in 2011, the anticipated tax cuts might encourage them to invest more.

In my judgment the first effect is far greater than the second effect, in no small part because I think the primary question investors ask themselves today is why should we make an investment today when the product demand isn't there?

So I think in the current recession environment, the whole set of issues around cost of capital is very much secondary. Maybe it is easier to put a plant in place today than it would be to put a plant in place 2 years from now, but if I do not have any use for the output that is going to come from that plant, there is no reason to build it today.

No conversation that I have had with leaders of organizations that invest in large scale suggest to me that their investment decisions today are driven, to any important extent, by what they think the corporate tax rate is going to be in 2011, much less what they think their own tax rate is going to be on any dividend payment they receive.

Senator Schumer. Thank you. Another quick question. Do you think we should, in this stimulus package, try to deal specifically with the housing crisis in certain ways? Or should that be apart from it?

Dr. Summers. I think it is a question more of legislative tactics than anything else. I think further action with respect to housing is a good idea. If you can do it all quickly in one package, so much the better. If the housing component is controversial, and putting it together with a stimulus package will delay the passage of stimulus, then I think you are better off keeping them on separate tracks.

Senator Schumer. Thank you, Dr. Summers. My time has expired.

Ranking Member Saxton.

Representative Saxton. Thank you.

Dr. Summers, I listened intently to your testimony and quite frankly it is very impressive, particularly with regard to the concept of targeting and timeliness.

With regard to targeting, I assume that your notion would be to target—or the correct notion, I should say, would be to target expenditures in such a way that they would give what I would call the most bang for the buck——

Dr. Summers. Yes.

Representative Saxton [continuing]. Of economic growth.

As I understood your testimony, you are targeting—you mentioned food stamps and unemployment insurance, and Dr. Mishel mentioned infrastructure repair. More recently, Senator Schumer mentioned issues that had to do with other sectors of the economy. Here is my question: As we sit here, as Members of Congress, there are going to be suggestions that come here to us from sectors throughout the economy as to what would give the most bang for the buck, and this Congress—the House and the Senate—will make decisions about what is the most bang for the buck.

And I can assure you that after 24 years here, I know there will be no shortage of ideas about how to do that, and that the political process will work to put in place something that the institution compromises on which will be different from what you say, or different than Dr. Mishel says; and I am wondering how we get around that problem which I see as a major impediment to a fiscal stimulus?

Dr. Summers. I think it is a very fair question. I think the reason why I emphasized relatively across the board tax rebates was because I thought they had the potential of avoiding what would otherwise me more devisive sectoral debates.

If this becomes the vehicle for everyone's particular agenda, then I think the process becomes that much more complicated.

In the name of being timely, I do think you should try to reach an agreement that is as across-the-board as possible. So while there are certain tax measures, or certain spending measures that seem to me to be particularly constructive, from the point of view of the long-run health of the economy, I have resisted the temptation to include them in my testimony, not because I am in doubt about whether they are good ideas, but because it seems to me that if everybody includes their preferred measures, you are going to have a very difficult process.

I also think that it is important to recognize that economics is about demand and supply, and they each have their day. At a moment like the present—when the principal risk is recession—the main problem is not that the economy has got various bottlenecks, but that the economy has got a lack of demand.

And so the priority should be to stimulate demand. Much of our longer-term policy thinking relates to the supply issues, whether it is education—as I would tend to emphasize—or whether it is reductions in top marginal tax rates, as others would tend to emphasize.

Unfortunately, because of these gathering recession pressures, the constraints on our economy over the next couple years are less likely to be about supply than they are about demand. And that diagnosis should frame the discussion.

Representative Saxton. Thank you.

Let me just very quickly ask Mr. Beach: Would the prospect, Mr. Beach—in your opinion—would trillions of dollars of tax increases after 2010 undermine investment and economic growth?

Mr. Beach. Yes.

Representative Saxton. A short question and a short answer. Thank you.

Senator Schumer. And your time has expired.

Congresswoman Maloney.

Representative Maloney. Thank you.

Dr. Summers, how important is it that we enact a stimulus package that does not worsen our long-term economic outlook, but boosts our competitive position in the world economy?

Dr. Summers. Two things, Congresswoman.

One, with respect to measures that would be adverse to the long-term fiscal outlook—I tried to address that in answering Congressman Saxton's question—but I would go in a slightly different direction with this and say I think it is very important for the long run that we avoid a recession, if possible. Because avoiding recession may be very difficult, we should focus on mitigating one to the maximum extent possible.

This is necessary because it seems to me, if you think about all of our country's medium-term and long-term objectives—whether it is the ability to address issues like health care, like income security, or like education—over the medium term, they depend on how strong our economy will be. They depend on what our budget outlook will be a couple of years from now, and that outlook will be very adversely affected if we have a serious recession.

The degree to which the United States is vulnerable in the global economy, at this moment of indebtedness, is going to be very sensitive to how strong our economy is, and how attractive we are as a place for others to invest. These two issues will depend very much on the seriousness of any downturn.

The attractiveness of the American model in the world—what my Harvard colleague Joe Nye has referred to as our "soft power"—is going to depend very much on how well our economy is functioning.

If you think about our ability to maintain support for an engaged internationalism, which I think is terribly important to do on a bipartisan basis in a rapidly changing global economy, it is going to be much easier to do that in the context of a strong economy that is producing benefits for middle-class families, rather than a deteriorating economy where economic insecurity is increasing.

So I think you hit on a crucial issue: There is enormous potential suffering that we can mitigate by responding to the threat of recession, but far beyond that, there are very large stakes for whatever the agenda of the country is going to be with new leadership beginning in 2009. I'm not talking about a Democratic agenda, or a Republican agenda, because whatever the agenda is, we are going to be in a much better position to accomplish it with an expanding economy than with a declining economy. The decisions we make in the next several months will affect very much how the agenda is framed a year or a year-and-a-half from now.

Representative Maloney. In this recession—or economic downturn—do you think it will be short and shallow, or deep and long? Dr. Mishel.

Dr. Mishel. I think that it is a dangerous thing to predict the future. And I think the comfort zone that we all agree on is, unemployment is going to be high in 2009. So that all the issues before us are: Let's do something to mitigate that. And I think that is the bottom line, and I think a lot of the technical talk about how deep is it going to go and will we actually see declining output doesn't matter.

Think about unemployment and what it does to families. Think about the people that are going to lose wages and jobs, the kids that will not be able to go to college, the people that are going to move around so the kids will be displaced from schools. I mean, just think about the permanent damage that is done as people lose income and suffer extended unemployment.

That is what I think Congress needs to focus on.

Representative Maloney. What timeframe do you believe is too late to have a proper stimulus on our economy? Anyone.

Dr. Mishel. I will just—well, I think we should implement something as soon as we can. And we would try to get a lot of the expenditure, both taxes or spending, implemented and going this year. But it could last into next year.

And I think as the other Larry has been saying, you know we can keep our eye out for whether we need to do more, but I think we should do something now. Keep our eye open. Anything that impacts the economy this year and early next year is well worth doing.

We are so far from having to worry about overheating the economy I just do not understand what the issues are.

Mr. Beach. Let me just have a quick word on that. You are already beginning to have an effect on the economy by holding hearings and having these debates. Your speech, if I could just say, is important to how people plan.

And you do not need to have definitive evidence of a recession to act. We know that there is a slowdown. We are all predicting a slowdown. And the mere prediction of the slowdown is in a sense going to be self-fulfilling because people will now be more cautious.

So there is right now a window for action. If you wait awhile and you do not signal what you are going to, on taxes, the legislative process is slow, so you are going to have to do something that will pass through quickly, you will miss the opportunity.

The credit markets are probably going to self-correct in some respects, wiping out businesses and taking care of borrowers. There is an action period and it is now. We know from 2001, when the action was taken in an appropriate fashion, that there was some bump-up in GDP. It wasn't a very effective move, but we know that that was a bump-up, so that moved now.

Dr. Summers. Congresswoman——

Mr. Beach. Go ahead.

Dr. Summers. [continuing]. It is an Olympic year. Gold medal for legislation in the first quarter with impact in the second and third quarter.

Silver medal for legislation in the second quarter that fully has its impact during this year.

And because this is a different kind of Olympics, no medal if the legislation——

Representative Maloney. Well said.

Dr. Summers. [continuing]. Does not happen in the second quarter and have its impact this year.

Senator Schumer. Thank you.

Representative Maloney. Thank you.

Senator Schumer. Senator Bennett.

Senator Bennett. Thank you very much, Mr. Chairman.

Welcome to all of the witnesses. First, Dr. Mishel, I endorse absolutely what you say about infrastructure. I cannot escape some historic context here.

I remember when we were passing the Highway bill. We were attacked as spenders, big spenders—drunken sailors; some of that language is still out there in the campaign rhetoric.

I voted for the Highway bill with great enthusiasm, even though I am a conservative Republican who is supposed to be concerned about fiscal responsibility, because I recognized exactly what you are saying here, not only because of the economics, but because our infrastructure is crumbling, as witnessed in Minneapolis.

And I am very interested that a lot of people who were saying, "Gee, you are spending far too much money! You are a bunch of drunken sailors up there who have lost control." When the bridge collapse said, "You did not spend nearly enough money on the infrastructure! What's the matter with you?"

Well that is the life we live here in the political world. But I think there is no question but what spending now on an infrastructure that is crumbling is the right thing to do. And if PAYGO requires that I vote for an increase in the gasoline tax, I will do it. Which signals that I am never going to run for President of the United States.

[Laughter.]

Senator Bennett. But I am interested in all of this conversation about unemployment and labor, because the reality is that we have, in various sectors of the economy, severe labor shortages right now that cannot be filled. This is not a single labor market where you either have a job or you do not have a job.

I will give you the anecdotal evidence. TVA is trying to rebuild certain facilities in the Tennessee Valley, infrastructure long since needed. They cannot find welders. They cannot find welders in Tennessee. They cannot find welders anywhere in the country.

They are advertising nationwide for welders to come work there, and for a variety of reasons that particular trade has dried up and people do not want to do it.

In my home State of Utah where unemployment is around 3 percent—having risen to that level from 2.6—the employers say: Our major problem is that we cannot find labor in a whole series of industries.

Now Utah may be an anomaly, but you do not have a single national labor market that is either filled or unfilled based on what the Congress does. And we could do serious damage to the economy, if in the name of trying to get the overall number changed, we do things that are not targeted to the reality out on the ground.

Mr. Beach, you say in your testimony you know others in the room who—let me read it exactly because it caught my eye. By the way, I think there is a misprint in your testimony because you have the question: What can increase risk? Didn't you want to say "decrease" risk?

Mr. Beach. Well, I am shocked that I made a mistake in my testimony, but I will go and take a quick look at that.

Senator Bennett. OK. But you say, "I am probably not the only one here today who knows the businesses that are preparing now for higher taxes."

Secretary Summers, I can introduce you to some people who will give you a different answer than the one you say you get from the people you talk to. I was in Senator Schumer's city talking to a group and said that the tax cuts are probably not going to be made permanent. Given the political situation, I do not see any chance that they will be.

They were absolutely stunned. They said, "Do you mean to say that all our taxes are going to go up? Back to where they were?"

I said, "Yes, that is exactly what the political landscape looks like."

They said, "Good heavens! Number one, we have got to immediately tell Congress how stupid that is. And Number two, if in fact that is the case, Senator, we have got to recalibrate all of our plans." Now that conversation was a year ago.

So let us not assume that 2010 is so far in the future, and we do not really need to worry about it, and it is not affecting decisions today. Anybody who makes the calculation that we are going to take our present circumstance where we have probably the highest corporate tax rate of any developed country in the world and see that go up so that we have the dubious distinction of being even higher, that that is not going to have an impact on the economy and that somehow that can just be fed into a computer and spill out numbers about deficits two decades from now is frankly not the kind of long-term economic thinking I think we need to do.

Now reactions from all of you to that particular tirade.

Senator Schumer. That's good, because your time is up, Senator.

Senator Bennett. All right. I apologize.

Senator Schumer. OK.

Dr. Summers. Senator Bennett, I think it is a balance-of-risks question, and clearly the impact of what happens on the tax cut would depend on how people thought about whether it was going to be paid for and what they think the impact would be on the long-run deficit.

I guess I am very struck by the experience of the 1990s, which I think was pretty powerful in demonstrating that putting deficit problems behind us exerted a very potent positive impact on the economy through its impact on capital costs. This positive impact occurred despite very strong warnings from many of the kind of people you are describing, who cautioned that the measures enacted in 1993 were certain to lead to a serious recession and a period of very slow economic growth.

So I think we probably do not see eye to eye. I recognize that the effects you are describing are present; I just think they are substantially exceeded by the adverse fiscal impact. And in any event, I think the worst risk here would be if that debate paralyzed us with respect to the measures that could otherwise be agreed on to provide stimulus to the economy in the short run.

I think if anyone were to have the idea that making the tax cuts permanent should be part of the stimulus, taking that position would on my assessment be tantamount to opposing stimulus. As you recognized, I do not think there is any conceivable chance that these two measures will happen in the next several months.

I think the decision is going to have to be made as to whether one is serious about the stimulus issue, and if so, that requires deferring any discussion around extending the tax cuts.

Senator Schumer. Senator Kennedy.

Senator Kennedy. Thank you, Mr. Chairman.

You know, just to get back to the reality, when we look at where we are in terms of—as this chart over here shows—on the problems of December's unemployment, if you look at what has happened in a number of parts of the country in terms of home heating oil—would you put that chart up, please—40 percent since the last year.

[The charts entitled, "Unemployment Rate Jumped in December" and "Real Oil and Gas Prices Approaching Record Highs" appear in the Submissions for the Record on pages 61 and 62 respectively.]

If you look at what is happening to American families who face losing their homes, this has gone up 181 percent from 2005.

If you look at the bankruptcies that have taken place just from 2006, this is up 40 percent. These are economic indicators. And they have triggered—for Mr. Beach saying, as well, we have got a window now. Action, period.

The results of all this are, people out there are suffering. And I think the enormous value that we have from this panel is the recommendation and suggestion that there are a number of things out there that can really help people that are being adversely impacted by this—however you want to describe it—this recession.

We should get about the business of getting something simple and quick that has been tried and tested and is going to have the greatest impact on those people that are hurting. I think that is what I am hearing from this panel. I think the recommendations have been enormously constructive.

I think Larry Summers and the response to the earlier question about giving out the medals just reminds us about the urgency. I do not know whether there is anything further that he would want to say on it, but I also am enormously impressed by what Dr. Mishel has mentioned: That even if we are able to get the economy moving in a more positive direction in terms of growth, we are going to have a lot of people that are going to be unemployed, and they are going to be hurting. They are going to be hurting.

I would just like to come back to that for a minute, if you can, for the panel. You have given us a sort of prescription about how we need to address the economy, but how are we going to lessen the impact on real people, on working families, people that have been the most adversely impacted up to now and are being adversely impacted while we are having this hearing here?

We could do one thing on the economy. We have something else with regards to the impact on real people. Dr. Mishel mentioned the changes in the unemployment compensation. These are people who are paid into the unemployment compensation and now are facing adversity. And instead of being able to get out what they have paid in, are still being shortshrifted.

That is a suggestion, and certainly one if we go the route of the unemployment compensation, but what, in addition to what you have said here, do you think would be valuable for this Committee to understand to lessen the impact on the people that are going to be really suffering through this period, even if we are able to get the economy moving back in a positive direction?

Maybe we will start with Dr. Summers, and then Mr. Beach.

Dr. Mishel. Well I would like to point out that the higher unemployment has its effect, not only on those people who become directly unemployed. And over the course of a year, you may have 6 percent unemployment, but 14, 15 percent of the workforce may be unemployed at some point during the year. But it is also the effect of the higher unemployment that lowers wage growth.

And so many working families will lose income because of that. And my friend Larry had an estimate of a loss for average families of $1,000, I think, this year. Mine is very similar with an additional loss next year of another $1,400 on top of the original $1,000. And so we also need to deal with those——

Senator Kennedy. Just describe that. What does that mean, the loss, to a family? What does that mean in real terms?

Dr. Mishel. That a middle class family who may have income of about $52,000, that as a result of the higher unemployment their incomes are going to be $1,400 less this year than what they were in 2007. And there will be a further deterioration in 2009.

So to me that is a pretty big deal.

Senator Kennedy. That is across the country? Is that across——

Dr. Mishel. On average across the country, yes. And I think it is going to affect everybody who lives in markets where unemployment is going to rise. And it is going to disproportionately affect those people who are at the bottom.

Listen, when we get 6 percent unemployment in this country, the minority communities are experiencing 12 percent unemployment. Communities who you could say live permanently in a recession are in a very, very deep recession.

But to move to the discussion about the unemployment insurance system that I know you are very interested in, I think it is really important for us to get on the table now—because we have done it so late in past recessions—to have some extended benefits for 20 weeks beyond the regular 26 weeks for all States.

And to be able to have in very high unemployment States even longer extended benefits and perhaps even a $50 per week benefit increase across the board. Unemployment Insurance benefits are very low, and we know these people are going to spend it. We know they are hurting. So that is a very easy thing for Congress to do.

And I also want to agree with my friend Larry that we should be thinking about stimuli that involve existing vehicles. No new programs. No changes in fundamental legislation. Let's use existing vehicles. It can be done for infrastructure. It can be done for unemployment insurance, food stamps, et cetera.

Senator Schumer. Thank you.

Dr. **Summers.** Could I add two things, quickly?

Senator Schumer. Yes.

Dr. **Summers.** One, Senator, I was struck by someone I spoke with recently who lives in New Hampshire and works in Massachusetts. You know, it is one thing for farmers to watch the weather report very nervously wanting to know what the weather is going to be, but it is another thing for people whose work does not have anything to do with farming to watch the weather report very nervously because whether they are going to be able to afford to heat their house all winter depends upon just how potent global warming is this winter.

I think that is an indicator of the kind of distress that becomes much more likely when you have a recession.

If you look at policy in historical context over the last 25 or 30 years, in a variety of ways we have much lower marginal tax rates than we did 30 years ago. In many ways that is a positive thing because of some of the other changes we have made, such as welfare reform. As a side effect of these other changes we have made—I would say mostly desirable changes—one adverse consequence has been that there is a little less automatic stabilization than there used to be.

Automatic stabilizers can be a useful policy tool because they kick in automatically as the economy declines. I think it would be worth some reflection, not just on what measures we can do right now, but on what automatic stabilizers might be useful. For example, we could reform unemployment insurance so that we have got a systematic set of formulae that extend benefits automatically when the unemployment rate goes down.

Similar kinds of changes could be useful with respect to other benefit programs. When the economy goes down and oil goes up, whatever the right size of the heating oil assistance program was 2 years ago, it should be bigger now.

So I think it would be profitable to consider some mechanisms for generating a little bit of automaticity that would lead to even more rapid responses in the future than is ever going to be possible through legislation.

Senator Schumer. Thank you.

I am going to try now to keep us within the 5-minute rule because we must end at 11:15 and I want to give everybody a shot.

Congressman English.

Representative English. Thank you, Mr. Chairman.

I have been concerned for months about a softening economy. I have been meeting privately with close to a dozen respected economists out of both the Government and private sector. What has struck me is there appears to be universal agreement that the economy is now slowing down, particularly based on the latest reports.

Many economists that I have met with recommend proactive stimulus, regardless of whether there is a technical recession—and certainly as somebody who represents Northwest Pennsylvania, I appreciate that whether or not it is technically a recession, it certainly feels like one, particularly when we slide below a 1 to 2 percent growth rate.

I would think this is not the time for partisan politics, but there are some legitimate philosophical concerns here that hopefully should not get in the way of our stepping in on behalf of working families now and acting quickly.

I would like to think there is a lot of common ground here. I would hope that we would have the courage to embrace a pro-growth stimulus package that would help jump-start the economy by helping job creators, as well as easing the financial burden on workers.

I think we need to extend full expensing and bonus depreciation for business investment, and limit the reach of the corporate AMT.

I would also like to extend unemployment benefits, repeal the income taxes on UC, increase the child tax credit, and provide a modest rebate for low-income families. I am not sure, Dr. Summers, that all of that could fit within your $50 to $75-billion parameters, and I am doubtful that we can recreate the miracle of the fishes and loaves.

But I guess I am more concerned about doing too little than doing too much. I also think that Congress should provide stability to the financial markets by making clear that the tax reforms enacted in 2001 and 2003 are not going to be allowed to expire. And I certainly would rather do that, rather than threaten tax increases of historic proportions, as were contemplated in recent budgets.

I think that if we are serious about stimulus, I think we should avoid over-promising, but also I think we should avoid some of the PAYGO rhetoric which seems to be hobbling action on the other side of the aisle.

I would hope in our discussion about infrastructure investment and handouts to States and certain programmatic tinkering, that we are not contemplating a stimulus package along the style that the Japanese embraced during the 1990s. That clearly did not work.

You will remember, Dr. Summers, when you were at the Treasury, the Japanese experience with that sort of stimulus really did not take them in the right direction.

Now Mr. Beach, you have talked I think eloquently about the impact of pending tax increases on calculations within the economy. Do you feel that the talk about tax increases, which has proliferated in Washington over the months leading up to our recess, has contributed to the threat of a slowdown? And do you believe that some of the tax reforms floated out there by some of our friends, particularly in my Chamber, have potentially contributed to the atmospherics which seem to be slowing growth?

Mr. Beach. Well, anecdotal evidence here is what we have. We do not have the statistical evidence yet, but I can affirm that based on conversations I have had and observations I have made.

I have also begun to suspect, and some research is now beginning to come in, that stock market volatility may be due to the threat of the increase in taxes as chief financial officers rebalance portfolios to produce cash-flows in 2010.

So, yes, I think that the discussions in the House recently on the Ways and Means bill which was I think a large tax increase may have contributed to uncertainty about the future.

Representative English. Dr. Summers—I know I am almost out of time—but you had mentioned the idea of a discretionary trigger being wired into stimulus.

Certainly we have discussed both programmatic stimulus and tax stimulus here. Are you comfortable with the idea of including discretionary triggers in the Tax Code? And doesn't that also potentially have unintended consequences?

I just wanted—I would like you for the record, because of the standing you have up here, to maybe offer your perspective on that.

Senator Schumer. You just have to do it briefly.

Dr. Summers. I don't think, Congressman, that there would be any significant adverse impact to a provision that would allow the Secretary of the Treasury over a 6-month period to certify that in his judgment recession had become more likely than not, and that an additional round of uniform rebates would go into effect.

Dr. Mishel. But not supply side tax provisions——

Dr. Summers. But I think, in general, we have a separation of powers, and pursuant to this separation, Congress legislates the tax cut. I think the exercise of discretion over a circumscribed set of measures and over a circumscribed interval, so as to provide for a better cyclical response might produce more accuracy than a quantitative trigger in terms of a 3-month move, but the discretion would need to be very much circumscribed.

Senator Schumer. Congressman Hinchey.

Representative Hinchey. Thank you very much, Mr. Chairman, and thank you, gentlemen, very much for being here with us today. I think we have all benefited greatly from the insightful testimony and the very interesting responses to questions that you have provided us. I am very, very grateful to you.

Dr. Summers, I wanted to thank you also for that mention you made of the Gold Medal, which I think is very interesting in this particular context. The price of gold is now, what, something above $900 an ounce.

Dr. Summers. Yes.

Representative Hinchey. Which has gone up a lot more rapidly even than the price of energy, including the price of gasoline, which indicates that a certain amount of investment capital is now focused on something that is a lot more secure than it might be in other places, putting more and more of that investment capital into gold.

I think that, in and of itself, is an interesting situation.

As you pointed out, I think the economy that we are dealing with is essentially a demand economy. It is an economy that is based on demand. Roughly 70 percent of the gross domestic product of our country is based upon consumer demand and consumer spending.

So in the context that we are dealing with what I think frankly, is a recession at this moment—I think we have seen a downturn in the economy continue over the course of roughly the last year, and I think it is pretty clear now that we are in the early stages of a recession.

And so if that is true, we need to begin to deal with this very aggressively in the ways that you have suggested. And I think that most of that has got to do a little with tax cuts, having those tax cuts focus on middle income, low or middle income people, blue and white collar working people. They are the ones that are going to generate the stimulation of the economy with whatever money they get.

They need to have additional spending ability. If you look at what has been happening to working people over the course of many, many years now, the unemployment insurance has not been what it should be. The minimum wage is not what it should be.

People who are working are not getting the kind of wages or the kind of benefits that they deserve. People who are in a situation where they get unemployment insurance for which they have to contribute in the context of their job, for them the cost of that unemployment insurance has gone up something in the neighborhood of $1,500 over the course of the last year or so.

So working people are really in distress here. And I think that we have to focus on the demand aspect of this economy and provide as much help as we can for these working people.

One of the ways that you talked about, both Dr. Summers and Dr. Mishel, was about investment in the basic infrastructure.

When you mentioned schools, Doctor, I was reminded of how the Clinton administration tried to get a substantial investment, public investment of capital into upgrading schools, which have not been upgraded in decades across this country. Many of them are in desperate condition. Those are the kinds of things that I think we should be engaged in.

We are facing what I think is potentially a very dangerous situation, not just with inflation, but with the value of the dollar dropping as dramatically as it has, and with the price of energy and food going up so substantially, making the inflation rate not 2.3 percent, but something in the neighborhood of 4.3 percent. That means we've got to have a large focus on this situation, which is likely, not just on inflation, but on something that confronted our economy back in the late 1970s and the early 1980s, a situation of stagnation of the economy down-turning and costs going up, resulting in "stagflation."

I think that is one of the words that we have to put in our minds as we deal with this complex set of issues that confront us right now—and I would appreciate what you think of that and how you think we ought to handle it in that context.

Dr. Summers. I would make two comments: First, how can we tell our kids that their education is the most important thing for their future and for our society's future, and then ask them to sit in classrooms all day, where the paint is chipping off the walls. How can we ask them to go work in chemistry labs, as we do all over this country, where the kids have to step out of the classroom three times during the experiments because they are sick and nauseated, because the ventilation system doesn't work? How can we ask our children to do these things and then talk about how we've got to produce more scientists?

There's plenty to argue about—how we should fund it, how quickly it should be implemented, and what its role is as part of stimulus—but it is hugely important. It was hugely important 8 years ago that we do something about infrastructure, and it's more important today,.

"Stagflation" is a big issue. Part of the reason why a balanced program of fiscal and monetary stimulus, is, in my judgment, a better idea than relying only on monetary policy, is because it's less likely to be inflationary for a variety of reasons, particularly due to commodity prices.

Senator Schumer. Thank you.

Congressman Hill.

Representative Hinchey. Is my time up?

Senator Schumer. Yes, plus 22 seconds.

Congressman Hill.

Representative Hill. Thank you, Mr. Chairman. I'm a Blue Dog Democrat in the House, and budget deficits and fiscal discipline is something that's very important to me. I think, in terms of the long-term health of the economy, it's very important.

We just recently passed, as you know, an AMT bill that threw PAYGO rules out the door, and here we are getting ready to do it all over again with this fiscal stimulus package, and I'm troubled by it, to be honest with you.

Now, there's been a great deal of discussion about the need for a stimulus package to be adopted, and that we ought to temporarily delay PAYGO rules, but all of you are so matter of factly convinced that this stimulus package is needed.

I looked at and read from a lot of different economists who are not convinced that it is needed. And it is going to contribute to the budget deficit.

Where is the empirical, historical evidence that past stimulus packages have contributed to the rebounding of our economy, particularly in the years 2001 and 2003?

Mr. Beach. Amen. I happened to bring along today, some graphs, which I'm happy to leave the Committee. They are from the——

Senator Schumer. Without objection, they will be entered into the record.

[The graphs referred to appear in the Submissions for the Record on pages 61 and 62.]

Mr. Beach. They're from the Bureau of Labor Statistics, and they go directly to your point. There are stimulus packages that work; there are stimulus packages that sound good, but are empty.

And the ones that we have tried, where we have stimulated demand, just haven't delivered as much as one would have hoped for them.

On the other hand, those that are targeted on the investment side, building new plant and equipment to create jobs and improve incomes, and, thus, through improving incomes, stimulate demand, tend to perform very, very well.

If you're going to suspend PAYGO rules, do it for programs that have a proven record of success, rather than ones that don't have a proven record of success. And it doesn't cost you a thing today to signal what you're going to do on taxes in 3 years.

That doesn't even qualify for the PAYGO rules, and your speech is important. I am very concerned about spending.

Spending is a drag on the economy, if it is for non-productive purposes or purposes which have less productive purposes than similar money used for private concerns and you're right to be concerned about it.

I would hope that Congress would find a way to get this done without having to depart from a discipline in the signal which was so important at the beginning of this year, that Democrats and Republicans are really going to be serious about spending.

Dr. Mishel. Representative Hill, I understand your concern for fiscal responsibility and I salute it. I would point out that all efforts to pass balanced budget amendments, PAYGO rules, always have, and for good reason, exceptions for a recession and a downturn.

And the reason is for what Larry Summers said, that if you put money into the economy through some kinds of spending or tax cuts and take it away in others, you end up not having an effect.

So if we do something that is temporary, that is a one-time thing and doesn't build into higher deficits forevermore, it makes a lot of sense.

I would also add that at this point, we have a deficit that's about 1 to 1.5 percent of GDP, which is actually a little bit higher than I would like at the end of a recovery, but it's not very large by historical circumstances, and I think that given what families are facing with higher unemployment and wage losses, that I think, to me, the concern should be on, as Larry says, mitigating the rise of unemployment, as long as we don't build in a permanent hole in the budget. I would suggest that would be a way to think about this.

Dr. Summers. Here's the problem: This is a case where preemption is probably a good idea. If you wait until it's absolutely 100-percent definite that we're in a recession, by the time your stimulus takes effect, it's going to be too late.

You know, I've followed the economic debate pretty closely, and I've been part of it. It makes a big difference, whether you're reading things that are dated January 14 or whether you're reading things that are dated January 2 because the data is really quite consistently coming in negative.

I don't think the risk is very great that this is going to be unnecessary, though I wish I had a different view.

The fiscal prudence certainly is a big part of it, and in the best of all worlds, you'd be legislating measures in the out years that would offset anything that was done in the in years.

I think that's a reason to focus on keeping whatever you do timely, targeted, and temporary, and to be serious about imposing that kind of condition.

But let me be very clear, stimulus is not going to pay for itself.

On the other hand, to the extent that stimulus is responsive to reigning in the recession, that's got a quite significant positive effect on the health of the economy, which feeds through into the budget over the longer term.

Senator Schumer. Thank you.

Last, but not least, Congressman Cummings.

Representative Cummings. Dr. Mishel, you used a term that I found so interesting. You talked about there are people in a permanent recession.

You know, yesterday, I saw something that was just so interesting. They were doing the election coverage up there in Michigan, and I saw a fellow who had been out of a job for 2½ years. He said he was putting in 10 applications a week.

And he couldn't move, either. He had a house. I think maybe his wife was working. I don't know, but the money was coming from somewhere.

And, you know, I said to myself, you know, this man is getting hit at least twice. He can't move, because he's worried about the price of his house which had dropped so far. Therefore, he was trying to wait it out, as to allow an opportunity for the price of his home to increase or gain value.

But at the same time, he didn't have a job. And I was just thinking, I was just thinking about some of the things that you and Dr. Summers have said. Is there such a thing as throwing good money after bad?

In other words, I think your organization talks about $100 billion, Dr. Summers talks about $50 to $75 billion to include in the overall stimulus package. Is there some point where you don't go high enough, and it does not do any good? Are you following me, gentlemen?

Dr. Mishel. Yeah. Our economic rebound plan actually recommends 1 percent of GDP which is $140 billion. I think Larry, who started out half that size, is now saying that we may need that much, and be ready to do it.

And I think that, you know, when you talk to people from the financial sector, or other people who talk as if they're looking into a deep, dark abyss, and if you don't throw a big lifeline to the economy, they're wondering, why bother? So you really do have to do something to scale.

And I know those stories that you're talking about with the man in Michigan, and it's a shame that our policies over the years haven't really done anything to address the kind of issues that that man faces.

And I would actually say that I wish we could also be talking about a policy of job creation in communities that always experience high unemployment, because whether or not we come out of a recovery or not, those communities are still going to need jobs.

I think we should be going even so far as direct government job creation, because those communities do live in a permanent recession, and they need training and they need access to jobs, so I applaud your attention to this.

Representative Cummings. Dr. Summers, how urgent is urgent? In other words, I think all of you said that we need to get a stimulus package to the American people quickly; we don't have to have a lot of arguments over. However, how urgent is urgent—because you know how this place runs up here?

Dr. Mishel. Start meeting tomorrow.

Dr. Summers. If the legislation is on the President's desk and signed within the next 2 months, you've done great. If the legislation is passed and on the President's desk and signed before you recess for Memorial Day, you've done OK. If there is no legislation before Memorial Day, but it comes before July 4th, you're passing. But if the legislation comes after that, it might or might not have been worth the bother, and the main opportunity to help has been lost.

Representative Cummings. So if you've got a preference between things like unemployment—dealing with those people that are closer to the permanent recession—or dealing with the tax cuts, I take it that you all have a preference there?

Mr. Beach. I don't think you're actually legislating for the recession or the slowdown right now, because I think you should be looking past it.

It's probably going to be slight, anyway. You know, it started in March, and it was over in November of 2001. The bill was signed in May; it took effect over the Summer, but really none of the effect really was there until late in the year.

So, in a sense——

Representative Cummings. You know, I wish you could tell that to the people I represent. They would not agree with that, because a lot of them fall within that permanent recession class, unfortunately.

Dr. Mishel. May I suggest also that he's suggesting—he's talking about GDP. And your own forecasts would say that the unemployment rate at the end of this year is going to be about 6 percent. You said it was 5.5 percent for the year as a whole.

So, it's not about when the economy actually contracts and when it stops contracting; it's how long people are going to experience high unemployment. I would hope you would agree with that, Bill.

Representative Cummings. Thank you, Mr. Chairman.

Dr. Summers. Real quick, as Senator Schumer suggested earlier, I'm no longer young. I've watched the economy, and I've watched Washington for at least a little while now, and I think the risks here of too little too late are far, far, far greater than the risks of too much, too soon.

Senator Schumer. And on that note, we'll conclude. I just want to say that the one consensus we seem to have among the witnesses, is that we should do this quickly.

There may be differences on what we should do. When I spoke to Chairman Bernanke the other day, that was his greatest concern, as well. So we've tried to set a good trend in this Committee. We were supposed to finish by 11:15. I know you have deadlines, and we came pretty close.

The hearing is adjourned.

[Whereupon, at 11:22 a.m., the hearing was adjourned.]

Submissions for the Record

JOINT ECONOMIC COMMITTEE
SENATOR CHARLES E. SCHUMER
CHAIRMAN

Opening Statement of Senator Charles E. Schumer
Chairman, Joint Economic Committee
"What Should the Federal Government Do to Avoid a Recession?"
January 16, 2008

Good morning and welcome to the first hearing of the New Year for the Joint Economic Committee. It is also the first Congressional hearing in 2008 to examine the most effective ways to stimulate the U.S. economy, which is teetering on the brink of recession.

We are lucky to have such a distinguished panel who I will introduce in a few minutes. But let me say 'thank you' at the outset to Larry Summers, my friend and the former Treasury Secretary. His willingness to make the time to be here today and think about these difficult issues during the course of his career make this Committee, the Congress and the American people better informed.

I also want to thank the JEC's Vice Chair, Congresswoman Carolyn Maloney from my home state, our ranking Republican, Congressman Jim Saxton; and Senator Ted Kennedy, who is the longest-serving member on the panel.

Economists from Former Federal Reserve Chairman Alan Greenspan to New York Times columnist Paul Krugman are suggesting that we are either in a recession already or on the brink of a recession.

The discussion of economic stimulus is no longer an academic exercise. In fact, real economic stimulus measures, enacted quickly, could be the last thing between us and a deep or protracted recession. The December downturn in retail sales and new concerns that auto loans and credit card payments could follow the pattern of mortgage payments and head south makes quick action on a stimulus package all the more necessary.

Even the current Fed Chairman, Ben Bernanke, said last week that the economic outlook for 2008 has worsened; and he listed all of the various forces that were dragging down the economy.

On Monday I called Chairman Bernanke personally to get his thoughts on the economy. And he said that fiscal stimulus is certainly needed and he would be generally supportive of the Congress and the President enacting such a stimulus. He said that while he wasn't going to endorse a specific plan, if an economic stimulus package was properly designed and enacted so that it enters the economy quickly, it could have a very positive effect on the economy.

In some ways, much of the bad news could have been averted. Last year, with the subprime mortgage crisis staring us in the face, this Bush administration was unwilling to act to stem that crisis and refused to consider the possibility that a recession was on the horizon. As many economists predicted (this committee included), the subprime mortgage meltdown spilled over into the broader housing market, damaged credit markets, and brought us to the precipice of a recession.

Because of presidential inaction to mitigate the effect of the subprime mortgage meltdown, the economy is now on the edge of recession. This nation desperately needs a strong stimulus package. There are six key points informing our actions as Democrats move forward on a stimulus package:

First, we want to work with President Bush to get something done quickly that will help middle class American families. There was much partisanship in last year's Congress, but the state of the economy makes imperative to put that partisanship aside and enact a stimulus package. Speaker Pelosi and Majority Leader Reid sent a letter to the President saying that they want to work with the White House and Republicans in Congress to achieve a stimulus package. And next week's meeting is a good first step toward achieving that goal. **We are prepared and willing to work with the President and Republicans to craft a bipartisan and balanced economic stimulus package.**

Second, we must enact a stimulus package that is timely, targeted, and temporary. Economists across the ideological spectrum agree that to deliver effective stimuli, the federal government needs to act with those three principles in mind.

- It should be targeted at the middle-class who will bear the brunt of the economic decline, and who with dollars in their pockets will provide the stimulus to the economy that is much needed.
- It should be timely because we can't introduce policies that won't kick in until long after a recession is already upon us.
- And finally, it should be temporary because we don't want to enact stimulus policies today that would permanently burden our children tomorrow.

Third, to be effective these proposals need to include a combination of tax cuts and spending stimuli. Direct injections of cash into the economy through both immediate consumer and government spending are the shots in the arm needed to ward off a recession. In fact, many economists believe that spending stimuli have a greater immediate effect on the economy than tax cuts because the former guarantee that the dollars authorized will be spent, while the latter do not. Both tax cuts and stimulus spending cash infusions are important because they support otherwise declining demand that stems from rising unemployment and falling household incomes. Monetary policy alone cannot address those necessary goals. An effective stimulus package, which includes both expenditures and tax cuts in combination with monetary policy, is the best way to avert a recession.

Fourth, as we create a stimulus package we must jettison ideological baggage on both sides. The last thing the economy needs right now is inaction while the parties fight old and ongoing battles. Renewing the Bush tax cuts, which don't expire until the end of 2010, should be off the table, because they will thwart any chance of passing a stimulus package. They are not timely, they are not targeted, and they are not temporary. Some Congressional Republicans may be planning to add these tax cuts to the stimulus package or even make them the centerpiece of the package. The President should resist such attempts especially in the Senate because they will impede or even kill such a package.

Fifth, on the question of pay-go – I believe that there is a growing consensus, not unanimous, in the Democratic caucus that paying for stimulus now would take away from the economic boost we are seeking to create. The stimulus, by definition, must have a net of spending over income.

And sixth, the administration needs to focus on the housing crisis and declining home values. The housing crisis has been the epicenter of this potential recession, and the President's hands-off approach to the housing crisis clearly has not worked. One foreclosure alone has costly ripple effects throughout neighborhoods and communities, and analysts are predicting two million more foreclosures over the next two years. We should take immediate, common sense measures to prevent unnecessary foreclosures and preserve the economic value of our nation's homes – a significant boost in counseling funds would go a long way in helping non-profits on the ground help families avoid foreclosure.

Fortunately, because of the important work of economists across the ideological spectrum and most recently yesterday by the non-partisan Congressional Budget Office, we know what works and what doesn't when it comes to economic stimulus.

We know that extending unemployment insurance is one of the most effective stimulus proposals because we've deployed it successfully in the past and it gets a lot of "bang for the buck." Lump sum payments to households in the form of tax rebates or tax holidays are also very effective ways to stimulate the economy.

On the other hand, we also know from experience that long-term tax relief for the very top is not successful stimulus.

Some of the important stimulus measures we are considering include: broad-based tax rebates, extending unemployment insurance and food stamps, targeted business tax cuts to stimulate job creation, and federal assistance to states.

It is long-past time to scrap the old Bush economic playbook of tax cuts for the wealthy as the only economic policy, and replace it with a balanced strategy that lifts the economic fortunes of all American families.

I hope that this hearing today and subsequent conversations with my colleagues and the administration will help us get to a bipartisan stimulus package that the American people deserve as quickly as possible.

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

Congressman Jim Saxton
Ranking Republican Member

PRESS RELEASE

For Immediate Release
January 16, 2008

STATEMENT OF RANKING MEMBER JIM SAXTON

Press Release #110-33
Contact: Christopher Frenze
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ECONOMIC STIMULUS

WASHINGTON, D.C. – I am pleased to join in welcoming the witnesses appearing before us today. The recent slowdown in the economy is a serious concern to the public and to policymakers alike.

According to standard measures of performance such as economic growth and the unemployment rate, the U.S. economy appeared to be doing quite well through the third quarter of 2007. However, more recent data indicate that the pace of economic growth slowed sharply in the final quarter of the year.

The recent economic data make clear that there are a number of challenges facing the economy. Residential investment declined at a 20 percent rate in the third quarter, continuing a longer trend. Housing prices are falling in many areas of the country, as housing inventory levels rise. Oil prices are near $100 per barrel, and the dollar is falling.

Since last summer, it has also become clear that a number of large financial institutions have invested in mortgage securities of dubious quality. Huge write-downs of assets by Citigroup and Merrill Lynch highlight serious concerns about the value of mortgage-backed securities. Uncertainty about the extent of bad investments related to subprime and other mortgages has spread, resulting in sharp declines in the valuation of bank stocks. Financial markets have become very volatile.

The Fed has acted by reducing interest rates and developing new ways to inject funds into the banking system. As a CBO report released yesterday noted, the federal government also has in place automatic fiscal stabilizers that have boosted GDP by an amount up to the equivalent of $350 billion in past downturns. The actions of a powerful central bank and these automatic stabilizers ensure that a policy response to any severe slowdown is already in place. Although most economists view Federal Reserve monetary policy as the best means to stabilize the economy, additional steps may be considered.

In considering its options, the first thing Congress should do is make sure its actions do not further damage the economy. For example, policymakers should resist the temptation to use targeting as a rationalization for channeling resources into earmarks at the behest of special interest groups or others. How all this new spending can be reconciled with the majority's PAYGO rules is rather unclear at this point.

Furthermore, as the CBO report notes, infrastructure projects are not appropriate components of economic stimulus legislation because these appropriations will not be expended quickly, but be drawn down over time. There is a real risk that a stimulus package will morph into a special interest Christmas tree. As a Congress Daily headline said yesterday, "K St. Lines Up for Slices of Stimulus Pie." With politicians designing the economic stimulus package, a positive impact on the economy is far from guaranteed.

Joint Economic Committee
Senator Charles E. Schumer, Chairman
Representative Carolyn B. Maloney, Vice Chair

Statement of Carolyn Maloney, Vice Chair
Joint Economic Committee Hearing
January 16, 2008

Good morning. I would like to thank Chairman Schumer for holding this hearing to examine the potential steps to avoid an economic downturn. I want to welcome our witnesses and thank them for testifying here today.

This summer's subprime crisis touched off an economic wildfire that still has not been contained. The housing wealth that consumers once relied on to fuel their spending – and the economy relied on to grow – is quickly evaporating as house prices continue their downward spiral.

Over the last several weeks, new evidence has emerged that a significant downturn in the economy may be underway. Last month, the unemployment rate increased by 0.3 percentage points – the most since right after the 9/11 terrorist attacks – and private sector job growth fell for the first time since July, 2003. Meanwhile, retailers posted disappointing holiday sales and manufacturing began to contract again, despite a weak dollar that has spurred exports.

Forecasters expect the economy to slow as high energy prices, falling home prices, and stagnant wages squeeze American families. A growing number of states are facing severe budget shortfalls due to foreclosures, declining property values and falling sales tax revenues, which will likely trigger cuts in education and health care for children and low-income families. All of which points to a gathering storm that could drag down the economy, taking thousands of American jobs with it.

It may be too late to avoid the second economic downturn of President Bush's administration. If it's like the last downturn, we may not know we're in it until it's already underway. But the technical definition of whether or when we have fallen into a recession is not likely to matter much to the millions of families for whom the Bush economy already feels like a downturn.

The economy could use a booster shot – either as a preventative measure or much needed medicine to stem the spread of the contagion.

House Speaker Pelosi and Senate Majority Leader Reid have called on the President to engage in bipartisan meetings to work out the terms of an economic stimulus package. The best chances for getting a stimulus package through Congress is one that is timely, targeted, and temporary – as Secretary Summers has advocated and even conservative economist Martin Feldstein has concurred with. Just yesterday, the Congressional Budget Office released a report saying that making the President's tax cuts permanent fails that test – it is neither temporary, nor targeted, nor timely. So if President Bush is serious about working with Congress, he will not bring that to the table.

Economists generally agree that the biggest bang for the buck will come from temporary measures targeted at low- to middle-income families. These could include one-time targeted tax relief for middle- and low-income families, extending unemployment insurance benefits, increasing low-income energy assistance and food stamps, and providing aid to the states so they can preserve Medicaid and SCHIP benefits that become even more critical during a downturn. Measures such as these get money to the people who need it the most, so they will put it right back into the economy fast and stimulate demand, with no serious risk of igniting inflation.

Initiatives targeted at bolstering the hard-hit housing sector, such as tax credits for green retrofitting and construction, could also be considered as a way to promote job creation while fostering greater energy independence.

Democrats in Congress are committed to working with the President and Republican leaders in Congress to quickly pass real reforms that will help America's working families. This may well set the tone for the coming year for Congress and the White House, and I am hopeful that we can work in a bipartisan manner to bring relief to American families.

Mr. Chairman, thank you for holding this hearing and I look forward to gaining some insights from our witnesses as to the best policies for strengthening the economy.

from the office of

Senator Edward M. Kennedy

of Massachusetts

FOR IMMEDIATE RELEASE
January 16, 2008

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KENNEDY FIGHTS FOR WORKING AMERICANS

Kennedy questions experts on economic downturn

United States Joint Economic Committee Hearing

(As Prepared for Delivery)

I commend Senator Schumer for holding this important hearing today about a deepening concern that is on so many Americans' minds – the troubled state of the nation's economy. And I join in welcoming our distinguished witnesses. Larry Summers is one of the nation's pre-eminent economists, and so is Larry Mischel, whom I've worked with for many years. I also welcome William Beach from the Heritage Foundation, and look forward to his testimony as well.

Americans are increasingly anxious about making ends meet. Many economists say a recession is coming and it may be severe. For millions of families, the recession is already here. They're seeing their jobs disappear, their savings gone, their homes at risk, and their costs going up week after week, month after month.

We're committed to action to stabilize the economy and relieve the distress that families are facing. We'll work with President Bush and our colleagues on both sides of the aisle in Congress to pass an effective stimulus package, but we've got to adhere to some core principles. First, anything we do should be quick and temporary. We need to get money into workers' pockets in 2008 to encourage spending and boost the economy. What we don't need are long-term tax cuts that will drag our economy down in future years.

Second, our plan should be focused on average Americans facing tough times. 90% of the benefit of any stimulus package should go to the 90% of ordinary Americans who work for a living, depend on their paycheck, and struggle to pay their bills. They are the ones who will make our economy start growing the fastest again.

Third, we need a robust package of reforms. We can't just tinker at the margins. Americans need real help that will make a real difference in their lives, and they need it as soon as possible.

That means additional unemployment benefits to help workers pay their bills while they look for new jobs. It means transitional health coverage, so workers don't lose their insurance if they lose their jobs. It means assistance to states, so they aren't forced to cut their budgets for critical necessities like Medicaid. It means emergency heating assistance for families swamped by the soaring cost of energy.

It also means emergency job training to help workers quickly gain the skills they need for new jobs. And we must increase food stamps so that low income workers can feed their families.

Last, but far from least, we should consider an immediate tax rebate for low and middle income families. A rebate makes sense as another effective way to help jump-start the economy, but we must be careful to reject any attempt to use this current crisis as a pretext for permanent new tax breaks for the wealthy or for Corporate America.

In all these efforts, we must be guided by a simple principle: People do not work for the economy; the economy should work for people. If we want an economic recovery that works – if we want real opportunity and sustainable growth – that effort starts and ends with working families.

Our economy is at a crossroads and we must act carefully to choose the right path for the future. It's time to rebuild an economy that puts working families first. I'm confident that we can do it, and I'm certain that we must do it. We owe the American people our best efforts, and I look forward to working with my colleagues on both sides of the aisle to put our economy back on track.

PREPARED STATEMENT OF DR. LAWRENCE H. SUMMERS, CHARLES ELIOT UNIVERSITY PROFESSOR, HARVARD UNIVERSITY

I am grateful for the opportunity to testify before this committee at this important juncture. I have submitted for the record a speech I delivered recently on the current state of the economy and the broad range of policy questions it presents. Here I address the main issues at stake in the debate over fiscal stimulus for the American economy and provide my views as of this moment. The best policy response may change as we receive new economic data and our understanding of the current, highly volatile economic situation improves.

1. IS FISCAL STIMULUS DESIRABLE AT PRESENT?

Yes. Following recent economic reports particularly the last employment report and yesterday's retail sales data, my judgment, like that of many economists, is that a recession is more likely than not. At this point this is or is very close to being a consensus judgment. Even if there is not an officially defined recession, there is almost certain to be a significant slowdown in the economy that will feel like a recession in many parts of the country and to many businesses and families.

Fiscal policy measures that succeed in increasing spending will mitigate the severity of the coming downturn and accelerate the eventual recovery. Crucially they will also provide insurance against the possibility of a scenario unfolding like that in Japan in the 1990s where an economic downturn becomes very severe and lengthy because a vicious cycle starts with credit problems hurting the real economy, in turn exacerbating the credit problems with the cycle continuing.

Over the next 2 years the difference between economic performance with and without fiscal stimulus is likely to be several hundred thousand jobs and a loss in the range of $1000 for the average family. If fiscal stimulus is successful in preempting a severe recession that would otherwise occur, the gains would be far larger.

2. WHY NOT RELY ON MONETARY POLICY TO STIMULATE THE ECONOMY AND FOCUS FISCAL POLICY ON LONGER TERM ISSUES?

As Chairman Bernanke recognized in his most recent speech, monetary policy has an essential role to play in maintaining demand and growth as well as in combating financial instability. In the current context however it is best complemented by fiscal policy for a variety of reasons: (i) in normal times fiscal policy is faster acting than monetary policy, and given the financial problems it may be even more true today. (ii) proper fiscal policies can target the innocent victims of recession and can directly promote job creation (iii) full reliance on monetary policy could easily mean lowering interest rates to levels that would be problematic for the dollar, commodity prices, future asset bubbles and moral hazard (iv) in a situation where policy impacts are uncertain it is most prudent to rely on a diversified set of stimulus measures.

3. HOW GREAT IS THE RISK OF OVERHEATING THE ECONOMY AND CAUSING INFLATION? SHOULD A DECISION ON FISCAL STIMULUS AWAIT DEFINITIVE EVIDENCE THAT THE ECONOMY IS IN RECESSION?

The balance of risks is now on the side of recession rather than inflation. Inflation measured by personal consumption expenditures excluding food and energy was 1.9 percent over the last year. Measures of inflation expectations as inferred from Treasury indexed bonds are close to their lowest point in the last 2 years. Moreover, in a climate of great uncertainty about workers' jobs and firms' profit margins inflation pressures are more likely to diminish than increase. Increases in inflation that have been observed recently reflect to a significant extent the impact of developments in oil as well as other commodity markets as well as declines in the dollar. Even if they are not reversed, these markets are unlikely have as large an inflationary impact in the future as in the recent past.

The major problem with past stimulus efforts is that the stimulus has come too late. If stimulus is to be timely, it should be delivered promptly. By the time it is conclusively established that a recession has started, policy is likely to have been substantially delayed from what would have been optimal.

There is sufficient weakness in the economy to justify stimulus legislation now with provision for rapid implementation. As discussed below, consideration should be given to providing for a second tranche of stimulus that would be implemented if/when clearer evidence of economic weakness appears.

4. HOW LARGE SHOULD A STIMULUS PACKAGE BE?

I have previously advocated stimulus in the range of $50–$75 billion. Given recent data, I now believe that it would be appropriate to enact a program of this magnitude as soon as possible and to make provision—perhaps with a contingent trigger for a second tranche of about the same magnitude.

Sizing a stimulus package cannot be reduced to hard science. A program of $50–$75 billion would represent .35%-.55% of GDP and would run very little danger of overheating the economy on any plausible scenario. If delivered in the second and third quarters of 2008 it could have a material impact on consumers and on confidence more generally. A larger program particularly if it contained measures that would have their impact only with a delay would on current evidence risk an imprudent pattern of expanding the budget deficit at a future time when growth had been restored.

However, policy has been behind the curve for some months now. So it would be appropriate to design further stimulus that could take effect without the need for new legislation and debate if the economic situation deteriorated either as Congressional debates continue or after legislation takes effect. The two tranche approach could deliver stimulus in the range of 1 percent of GDP if the situation warranted. One reasonable trigger would be changes over a quarter in payroll employment as suggested by Martin Feldstein. An alternative or supplement would give the executive branch the right to trigger the second tranche of stimulus based on their assessment of economic conditions.

5. WHAT SHOULD COMPRISE A STIMULUS PACKAGE?

As with any potent medicine, stimulus if misadministered could do more harm than good by increasing instability and creating long run problems.

A stimulus program should be timely, targeted and temporary.

Timely stimulus requires both that Congress and the President act quickly and that measures be chosen which can be implemented rapidly and then which will have their ultimate impact on spending in short order. This puts a premium on simple measures that work through existing modalities such as adjustment of withholding schedules or tax refunds or enhancements of benefits. It calls into question the wisdom of designing new programs or using approaches where Federal spending is not injected fairly directly into the economy but is instead only transferred to other units of government that historically have spent out new funds only gradually.

Targeted stimulus requires that funds be channeled where they will be spent rapidly and where they will reach those most in need. This also argues for use of simple changes in withholding schedules, or tax refunds as well as for change sin benefit formulas. In general targeting in both the sense of assuring maximum spending and fairness are likely both to be achieved by measures that target those with low incomes and whose incomes have sharply declined.

Temporary stimulus is necessary if stimulus is not to raise questions about the country's long run fiscal position. If stimulus were not credibly temporary, it would likely raise long term interest rates and increase capital costs offsetting its positive impact. Moreover if stimulus is not temporary, the risks that it will continue even after the economy recovers and lead to inflation or very high interest rates is greatly increased. *Stimulus should be designed so that its proximate impact on consumer or government spending is all felt within a year of enactment and in any event by the end of the first quarter of 2009.* It is important also that no measures be enacted on a temporary basis that will generate overwhelming political pressures for their extension if fiscal credibility is to be maintained.

On the tax side these considerations suggest the desirability of across the board equal tax cuts or refunds for all taxfilers Measures which reduce taxes in proportion to taxes currently paid or that disproportionately favor upper income taxpayers or recipients of capital income are likely to be far less effective as such taxpayers spend much less of new income than low and moderate income taxpayers. Measures which commit today to reduce future taxes relative to current law are likely to be counterproductive because of the fiscal doubts they raise and because they do not provide liquidity now at the moment when consumers are facing the need to cutback spending.

My reading of the evidence suggests that the case for business tax cuts is not compelling. The principle inhibitor of business investment right now is lack of market demand not the cost of capital. And the experience with the 2001 stimulus program is not very encouraging with respect to the efficacy of business incentives as stimulus. On the other hand a temporary investment tax credit or accelerated depreciation scheme might pull some investment forward from future years into 2008. To maximize the bang for the buck such a program should be incremental and apply only to investment above some benchmark such as 2/3 of previous investment or depreciation.

On the spending side the measures most likely to be effective are temporary increases in benefits perhaps for the long term unemployed and food stamp recipients. Such increases can be implemented quickly and go to people who will spend them fast. The more detailed efforts are made to achieve specific programmatic objectives through increased spending, the greater the risk of delays. A high burden of proof should be put on any new spending program proposed as a stimulus measure to demonstrate that the spending will be rapid.

6. SHOULD STIMULUS BE PAID FOR WITHIN A GIVEN BUDGET WINDOW?

Fiscal stimulus to an economy in recession operates by increasing demand in an economy that is constrained by lack of demand. If it is paid for contemporaneously, its point is largely lost as there is no net stimulus to demand because money injected in one area is withdrawn in another.

As long as a fiscal stimulus program is temporary and does not create expectations of future spending or tax cuts it does not make a large economic difference whether or not it is offset by specific future fiscal actions. Including offsets in a 5 or a 10-year window would magnify the impact of fiscal stimulus a little bit by reducing any adverse impact on capital costs because it would avoid any increases in long run debt levels. And the need for offsets might operate to prevent fiscal stimulus from being extended or allowed to grow excessively.

On the other hand, if it delayed the process of coming to a conclusion on fiscal stimulus or generated so much disagreement that timely legislation could not be enacted a requirement of offsets would have serious adverse consequences. A judgment on offsets is ultimately political—depending on the economic advantage of the extra discipline offsets bring relative to the disadvantage of the extra complexity and delay that their negotiation would require.

RISKS OF RECESSION, PROSPECTS FOR POLICY (BROOKINGS INSTITUTION: STATE OF THE U.S. ECONOMY)

I am speaking here today because I believe that our current economic situation requires a comprehensive program of measures to contain the fallout from problems in the financial and housing sectors and to assure sufficient policy support for economic growth over the next several years. Perhaps because of a failure to appreciate the gravity of our current situation and the problems our political process has in responding quickly and collaboratively to emergent threats, such a comprehensive program is neither in place nor in immediate prospect.

No economic projection put forward with anything like complete confidence should ever be trusted. The current consensus suggesting that growth is likely to be slow over the next several quarters and that the odds of a technically defined recession are in the 40 percent range is troubling enough given that it means rising unemployment and budget deficits, likely falls in real family incomes and a downturn in plant and equipment spending.

For the last year, the economic consensus, and the policy actions that have flowed from it, has been consistently behind the curve in recognizing the gravity of the problems in the housing and financial sectors and their consequences for the overall economy. This continues to be the case. In my view it is almost certain that we are headed for a period of heavily constrained growth, quite likely that the economy will experience a recession as technically defined and distinctly possible that we are headed into a period of the worst economic performance since the stagflation of the late 1970s and recessions of the early 1980s.

The late Rudi Dornbusch was fond of remarking that in economics “things take longer to happen than you think they will and then they happen faster than you thought they could.” So it has been recently. The related but distinct patterns of excessive valuations in housing markets and excessive complacency in credit markets were pointed out for years by experienced observers. The cracks took longer to appear than many expected and have now proven to be far more structurally damaging than almost anyone supposed.

Economic downturns historically come in two categories. For most of the post war period, economic expansions did not die of old age. They were murdered by the Federal Reserve in the name of fighting inflation. This was the story in 1958, 1971, 1974 and 1982 as sharp increases in credit costs drove the economy into downturns.

Before World War II, and in recent years as inflation has come under control, expansions have ended as a consequence of the workings of the financial system, sometimes in conjunction with oil shocks. After a period of optimism, asset prices expand beyond fundamental values, credit expands, investors embrace financial innovations that allow greater leverage so as to better take advantage of rising asset values. At some point the party ends, asset prices fall, financial structures that once looked impregnable become vulnerable, confidence collapses, propensities to consume and invest fall off, and the economy turns down.

Experience suggests that downturns driven by falling asset prices and credit problems tend to be recognized relatively slowly and to be quite protracted. Two extreme examples are the American experience after 1929 and Japan's experience in the 1990s after the 1989 asset price collapse. Our last two recessions associated respectively with the bursting Savings & Loan real estate bubble and the NASDAQ collapse revealed gaps of several years between asset price peaks and the restoration of satisfactory rates of economic growth. Nationally housing prices peaked less than a year ago, and credit spreads reached their minimum levels only about 6 months ago.

History's caution that situations like our current one are likely to surprise on the downside for a considerable time and prove quite protracted is confirmed by forward looking indications regarding the economy.

- 300,000 home foreclosures were initiated in the first half of last year. The vast majority of them involved mortgages that had not yet reset. Even with recent policy changes up to 1 million foreclosures are expected over the next 2 years.
- The new and relatively crude futures markets that exist are predicting that peak to trough national housing prices will fall by 24 percent according to an index that has only declined 6.6 percent from its peak so far. Already prime mortgages are defaulting at the same rate sub-prime mortgages defaulted 3 years ago.
- Freely traded shares in Real Estate Investment Trusts (REITs) are suggesting that the value of commercial real estate if marked properly to market may be down by as much as 20 percent and the rate of transactions in commercial real estate has declined by more than half over the last year.
- The most important driver of U.S. economic growth over the past 7 years has been consumption which has outstripped GDP growth. The combination of a near zero personal saving rate, lost housing wealth, reduced availability of credit, reduced real incomes caused by rising oil prices, a falling dollar and rising food prices and increased uncertainty constitute a perfect storm depressing consumer spending.
- Even looking out 5 years the spread between safe liquid Treasury borrowing rates and the rates at which major financial institutions borrow is at well above normal levels. The debt of some of our countries largest and most prominent financial institutions is trading at levels suggesting a market judgment that their odds of defaulting on their debts over the next five years approach one in ten.

Of course it is possible that improved trade performance coming from the falling dollar, the working through of the Fed's monetary policy actions and typical American resilience will carry us through the next year robustly. But this is not where the preponderant probability lies.

Economic policymaking is about balancing risks. I have already suggested that the probability of subpar growth exceeds the chance that growth will be robust. There is an additional crucial point as well. The adverse consequences of policy choices that fail to deal with a potential recession and fail to stimulate the economy and that do not allow for financial repair far exceed the adverse consequences of over-insuring against an economic slowdown.

Consider the costs if we experience even in a relatively mild recession:

- Losses of close to $5,000 in income for the average family of four quite heavily concentrated among the disadvantaged who are inevitably last hired and first fired along with cutbacks in Medicaid, child welfare and other social safety net programs as state budgets contract.
- A several hundred billion dollar increase in our national debt and a significant reduction and a substantial cutback in investment in plant and equipment, education and R&D
- Hundreds of thousands more foreclosures and greatly increased risks to the financial system.
- Greatly complicated international relations as the our downturn slows the rest of the world economy, the American economic model is called into question, protectionist pressures rise, and the dollar's centrality to the international financial system is called into question

Of course if a downturn turns into more than mild recession, the risks are that much greater.

Against these risks, what do those who counsel against what they see as imprudent activism worry about? They fear that stating the need for strong action will somehow undermine confidence by laying the problem bare. And they worry that inflation might tick upwards or that those who have made financial errors will be insufficiently punished.

I only hope that history will see these as the main economic problems faced by whoever is elected President of the United States in 2008.

It is the great irony of financial crisis that the very measures that could have prevented crisis are counterproductive in a time of crisis. Of course it would have been better to have had more fear on the part of lenders, less rampant liquidity, and higher saving 2 years ago when imbalances were building. But that is not what we need now.

The most urgent priority for policy over the next several months is containing the incipient economic downturn. I am convinced this is possible without giving rise to either excessive complacency in the future or accelerating inflation. I want to briefly sketch what would seem to me on current information to be the appropriate evolution of policy in a number of areas. Of course as data comes in and alternative measures are debated, any particular combination of policies might look less and less appropriate. I will have served my purpose if I have advanced the debate by contributing an example of an ambitious policy program.

MONETARY POLICIES AND THE FINANCIAL SYSTEM

One former economist official whose advice I sought in preparing these remarks referred to recent events as "adjusting for raised expectations, the greatest failure of risk management in financial history." This is too apocalyptic. But it is suggestive of the extent to which major financial institutions are unsure of their own and their counterparties creditworthiness.

In normal times the spread between the rate at which the Treasury borrows and the LIBOR rate at which banks lend each other money for 3 months is typically well under half a percentage point. Currently it is about 2 percentage points. In the United States and Europe large and persistent spreads have also opened between the policy rates of central banks and the lending rates at which banks make credit available to each other and to firms and households.

In this environment the dominant risk is a downward spiral in which financial problems curtail credit and spending thereby reducing economic activity, which in turn exacerbates the financial problems, creating a vicious spiral. Once in progress, such a spiral may prove very difficult to arrest. It is much more important to establish credibility that policy is ahead of the credit crunch spiral than to reassure yet again that it is not behind the inflation curve.

I say this not because I am unconcerned about inflation. The achievement of price stability over the last generation is one of the most important factors contributing to improved economic performance. It is a matter of balancing risks. With workers and firms as insecure as they are today, I see little risk of the kind of wage-price cycle that has set off inflation in the past. Data on indexed and nominal bonds suggest that despite what has happened to oil prices and to the dollar there has been no increase in the expected price level several years out. Moreover, failure to contain a credit spiral could cost the economy years of satisfactory economic performance. If I am wrong and policy creates undue inflation pressures, they can be removed at a much less perilous moment.

So far the Fed has responded by cutting its policy rates by a full percentage point and with a number of programs to make liquidity available to banks. The seriousness of the problems is suggested by fact that liquidity provision has not yet made a large dent in the spread between bank and government borrowing rates. While reductions in policy rates have translated directly into lower lending rates, it appears that half or more of their impact has been offset by increases in the spread between policy and lending rates. This means that the apparent easing in monetary policy in recent months has been much greater than the actual easing.

What does this suggest going forward? First it suggests that policymakers should consider focusing attention not on their traditional policy rate but on targeting some more meaningful indicator of the cost of credit to households and businesses (such as 3 month LIBOR). In this way, increases in credit risks will not automatically translate into de facto tighter policy as they do today.

Second, assuring full transparency with respect to the valuation of assets and the recognition of losses and liabilities should be the top regulatory priority. The Japanese experience taught painful lessons about the dangers of government support and encouragement for measures that seek to rearrange balance sheets so as to avoid facing painful realities. Wherever possible assets should be marked to market, not to model, and liabilities should be explicitly recognized.

Third, regulatory policy needs to focus on assuring that financial institutions raise adequate amounts of capital to maintain their activities, even if this is painful for existing shareholders. If a bank is at the point of indifference between reducing the size of its balance sheet and raising capital by issuing shares or cutting dividends, the broader economy is not. Policy in recent months has devoted considerable attention to destigmatizing and indeed encouraging borrowing in one form or other from the Fed. In the months ahead it will be equally important to destigmatize the raising of capital and indeed to insist that institutions raise enough capital to allay credit risks and permit the resumption of normal lending activities.

FISCAL POLICIES

The success of the Clinton 1993 budget plan in setting off a virtuous circle of growth, reduced deficits, lower interest rates and still more growth—along with a growing sense that short-run stabilization policy is the job of the Fed—have reinforced the economics profession's growing aversion to the use of fiscal policy to stabilize the economy.

Yet, if economic data over the next several months come in as I fear they will—with increasing signs of recession—several considerations suggest that the policy response should include fiscal as well as monetary stimulus for several reasons.

If policymakers are able to act quickly and effectively, fiscal policy can work more rapidly than monetary policy, which has about a lag of a year between the change in the Federal funds rate and its maximum impact. Moreover, the efficacy of monetary policy may well be diminished by capital constraints that limit the ability of banks to lend or by creditworthiness constraints that limit the ability of businesses to borrow. As important, the extent to which monetary policy can be prudently used in the current environment is limited by concerns about the dollar as well as about the bubble creating effects of very low interest rates. Finally certain problems—such as the impact of mass foreclosures on affected communities—are not easily amenable to monetary policy.

Fiscal stimulus is critical but could be counterproductive if it is not timely, targeted and temporary. Gene Sperling's Bloomberg column this week makes these points strongly. To respond to an incipient downturn, fiscal policy has to have its impact in a *timely* manner. It has to be *targeted* to assure that increased government borrowing translates directly into increased spending and demand. And, critically, it has to be *temporary* so that its effects are not offset by higher long-term interest rates. Indeed from the point of view of stimulus, the optimal package is one that raises spending and the deficit in the short run while reducing the deficit in the long run and thereby reducing long term interest rates.

Any actual fiscal stimulus program would have to be worked out in the context of events as they unfold and should be walled off from longer term policy considerations where actions to assure long term fiscal sustainability are essential.

It is reasonable to suggest that stimulus approaching \$50–\$75 billion—roughly in the range of ½ of 1 percent of GDP—is likely to be appropriate. The largest part of this stimulus should come in the form of tax cuts distributed equally among all taxpayers and recipients of tax refunds. Other elements of a stimulus package should include extension of unemployment insurance benefits given that long term unemployment is already at recession levels, temporary step-ups in food stamp benefits which can be executed and have effect very quickly, and tax measures to eliminate from taxation the so-called income that homeowners receive when they are foreclosed, a step that has just been passed by Congress.

In the context of a legislative stimulus program, consideration also should be given to steps that can be taken to help contain energy and food prices. Such measures both raise consumers' purchasing power and reduce inflation concerns. These might include reform of the strategic petroleum reserve to assure that the government stops the practice of accumulating especially scarce oil products at times when markets indicates that current supply is selling at a large premium, and adjustments in policies promoting ethanol to assure that they do not drive up food prices.

HOUSING AND MORTGAGE MARKET POLICY

Probably the single most important thing economic policy can do for homeowners is to minimize the risk of recession or the severity of recession if it comes. With the bursting of what now can clearly be seen as a pervasive bubble, and the drying up of important segments of the mortgage market, the last thing that the housing market needs is a recession that would reduce incomes of homeowners and potential purchasers. That is why the aggressive fiscal and monetary policies I have just discussed are so important.

But it is also true that problems in the housing sector are an important reason for recession fears and they need to be addressed. The recent teaser-freezer (which freezes the initial teaser rate of some sub-prime mortgages) is a useful step that addresses that relatively small minority of subprime mortgage holders who on the one hand appear very unlikely to be able to get a new mortgage and on the other hand appear very likely to be able to carry their existing mortgage. It is a constructive step but I know of no credible estimate suggesting that it will reduce annual mortgage payments by more than about $5 billion.

It is a perhaps appropriate component of a much broader strategy that recognizes the core problems posed by the sharp decline in housing prices. While the issue of resets is an important one, a much more fundamental problem needs to be addressed. Consider a homeowner who purchased a home for $250,000 putting nothing or next to nothing down implicitly relying on appreciation of the house to service the mortgage. That homeowner finds himself today with a home worth perhaps $220,000 and with the capacity to service perhaps $200,000 worth of mortgage even before any rate reset. If the house is foreclosed, its value will probably decline to $150,000 and adversely affect the neighbors as well.

The best outcome for both borrower and lender is a write down in the value of the mortgage that allows it to be serviced and at the same time prevents a mutually costly foreclosure just as Chapter 11 of the bankruptcy code prevents the liquidation of overly indebted but viable companies. It is deals of this kind in the subprime, alt A, and prime space that need to be negotiated if families are to be saved the agony of foreclosure and lenders are to maximize their recoveries.

The answer may lie in bankruptcy law reform, standard templates for mortgage restructuring or other means. Various tax and regulatory obstacles to shared appreciation mortgages in which lenders reduce monthly payments in return for a share in a house's appreciation when it is sold should be removed. Until there is recognition that many individuals who cannot meet their original mortgage obligations are nonetheless the highest value occupants of their homes, we are not going to fully respond to the problems in the housing sector.

Additional steps that should be taken in the next several months include:

- the provision of Federal assistance to those who are foreclosed in locating new rental housing and to communities that wish to purchase foreclosed homes and convert them into rental properties.
- support for an adequate supply of mortgage credit. Proposed increases in the availability of FHA guarantees are a positive development though they are manifestly insufficient to assure an adequate flow of mortgage capital across the entire housing spectrum.
- The Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, should be granted significant temporary increases in their portfolio limit so that they can perform their market stabilizing function at the time it has been most needed in two generations. They should also be freed on a temporary basis from punitive capital requirements and the conforming loan limit should be increased to about $600,000.

It is of course possible that developments in the housing sector will prove less serious than I fear and that not all of these measures will have been necessary. How serious a problem will this be? A substantial fraction of the originators of subprime mortgages have gone bankrupt. If I read the political winds correctly, those who remain will face greatly enhanced regulation. The concern that too many homeowners will learn from these events that it is a good idea to excessively lever up their homes seems less than paramount at this point. On the other hand, if policy remains behind the curve families in communities across the country will bear the brunt of the errors.

CONCLUSION

While it has not been my topic this morning, I trust that extensive efforts will be made to learn from painful experience. Most obviously and visibly there is the need to protect vulnerable people from the kind of predatory lending practices that have been all too common in recent years. Recent experience also suggest the need for reevaluation of traditional approaches to monetary policy, the regulation and provision of liquidity to different types of financial institutions, the role of the rating agencies and much else.

It has always seemed to me that those of us involved with finance bear great responsibility. There is the great importance of well functioning capital markets and the credibility of the currency. Much more important is the reality that when the economy is successfully managed people's fortunes are determined by their own choices and efforts. When the wrong economic policy choices are made people's lives can be wrenched apart as they lose their jobs or their homes or their ability to provide for their family because of complex forces entirely beyond their control.

The economy is at as critical a juncture as it has been in many years. Policy must balance risks at a highly uncertain moment. The lives of millions of people who will never think about countercyclical policy, moral hazard, lending facilities or the Federal funds rate may be profoundly affected by the policy choices made in this city in the next few months. I hope they will be made both urgently and wisely.

PREPARED STATEMENT OF DR. LAWRENCE MISHEL, PRESIDENT OF THE ECONOMIC POLICY INSTITUTE

Mr. Chairman and members of the Committee, I am Lawrence Mishel, President of the Economic Policy Institute. Thank you for this opportunity to explain why the U.S. economy needs a large economic stimulus to boost demand for goods and services and to prevent a serious and protracted loss of jobs and rising unemployment. My testimony will make three key points:

1. Because the economy, and especially the labor market is in serious trouble, immediate intervention of sufficient size is needed to prevent a vicious cycle of job loss and reduced consumer demand and spending.

2. The right stimulus will have the biggest bang for the buck, which comes from increasing unemployment compensation, providing state fiscal relief, issuing targeted tax rebates, and direct Federal spending on low-income families through such means as increases in food stamps.

3. Infrastructure spending, especially school repair and maintenance, can be done quickly and can efficiently put a million people to work. But even if it takes a year or more to employ large numbers of workers on infrastructure projects, the impact will be timely and important in counteracting rising unemployment and the kind of glacially slow job creation we saw following the 2001 recession.

The economy has been broken for some time, and the economic growth we have seen has not reached the vast majority of families. This will probably be the first business cycle where, at the end of the recovery (last full year being 2007), the typical family will have lower incomes than they did at the start of the downturn (2000, the last full year of recovery). Fixing this disconnect between growth and the pay and incomes of the vast majority of Americans requires a policy agenda on health care, retirement, labor policy, trade policy, and work/family policy that is much more substantial than what we will be talking about today. The focus today should be on offsetting the rising unemployment and the corresponding income losses that families will shortly face.

1. THE ECONOMY AND JOB CREATION NEED A BOOST

The economy is taking hits from all sides. December's declining retail sales figures show that consumers are already hurting. Housing prices declined by a record 6.7 percent on an annual basis, according to the most recent S&P/Case-Shiller Home Price Index, and given the record inventories of unsold homes, they are expected to fall further.[1] Home foreclosures are on the rise: the largest U.S. mortgage lender, Countrywide Financial Corp., reported that foreclosures and late payments rose to their highest Ievels on record in December 2007.[2] And, over the next 6 months, the number of adjustable rate mortgage re-sets will exceed those that occurred in all of last year.

Let me be clear that we need to keep our eyes on rising unemployment and weak job growth and not on technical issues of whether output (GDP) actually contracts. Even slow but still positive economic growth can lead to sharply rising unemployment from job losses or very modest job gains. Job growth slowed over the past year, and that weakness has shown up in the unemployment rate, which jumped to 5 percent in December, significantly higher than the 4.5 percent unemployment rate in the second quarter of 2007. A jump of this size is usually the sign of a recession, and analysts at Merrill Lynch and Goldman Sachs believe that a recession has al-

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[1] See S&P, "Broadbased, Record Declines in Home Prices in October According to the S&P/Case-Shiller® Home Price Indices" at *http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice*_Release_122622.pdf

[2] Reuters, "Countrywide says foreclosures highest on record" January 9, 2008, at *http://www.guardian.co.uk/feedarticle?id=7211734.*

ready begun.[3] Goldman Sachs projects that the unemployment rate will reach 6.2 percent by the end of 2008, which will put additional downward pressure on wages and incomes, further reducing consumer demand.

If the economy is to avoid a cycle of declining consumer demand that fuels more job losses, which in turn reduce consumer demand, Congress must act quickly. If bold action isn't taken, we are likely to see a repeat of the 2001 recession and the years of jobless recovery that followed it. EPI released a plan last week, which I have submitted as an attachment, that provides $140 billion of stimulus—1 percent of GDP—which would begin to reverse our economic course by creating an additional 1.4 to 1.7 million jobs.

The stakes are high. In the last recession, the economy received only a mild boost from the 2001 tax legislation, primarily from a provision that provided a $300 rebate to most taxpayers. The bulk of the legislation was vastly misdirected and provided, little immediate stimulus. The consequences were a sustained rise in unemployment and no job growth until late in 2003: job growth, wages, and incomes all stagnated well beyond the "official" end of the recession.

2. UNEMPLOYMENT COMPENSATION EXTENSIONS AND STATE FISCAL RELIEF SHOULD BE THE HEART OF ANY STIMULUS STRATEGY

The Democratic leadership has announced that any intervention should be "timely, targeted, and temporary," and I agree. Targeted should mean targeted where it can be most effective as stimulus, and it is a fact that all so-called stimulus is not equal. In fact, the key to maximizing its effect is to put money into the hands of consumers who will spend it most quickly and to create jobs, breaking the cycle of job loss and falling consumer demand. The fastest, most efficient way to get an infusion of money into the economy quickly is direct government spending on people who need help.

Estimates by the U.S. Department of Labor and by Mark Zandi of Moody's Economy.com rank unemployment compensation at the top of the list of possible stimulus choices, increasing demand by $1.73 to $2.15 for each dollar. By contrast, Zandi finds that tax cuts—of all possible cuts—rank lower, and reducing the estate tax ranks lowest of all possible stimulus choices.

High "Bang-for-the-Buck" stimulus:	
Extend unemployment benefits	$1.73
Provide state fiscal relief	$1.24
Enact a one-time uniform tax rebate	$1.19
Increase Child Tax Credit	$1.04
Lower "Bang-for-the-Buck" stimulus:	
Adjust Alternative Minimum Tax exemption levels	$0.67
Reduce marginal tax rates	$0.59
Increase tax breaks for small business investment	$0.24
Cut taxes on dividends and capital gains	$0.09
Reduce estate tax	$0.00

Extend unemployment benefits

Along with the National Employment Law Project, the Coalition on Human Needs, National Women's Law Center, the AFL–CIO, and many unions, we strongly recommend immediate creation of a 1–year emergency unemployment compensation program with 20 weeks of supplemental benefits in all states and 13 additional weeks in "high unemployment" states (those with a 3-month average unemployment rate of 6.0 percent); a $50 per week benefit increase; and additional administrative funding. Congress should not wait for further damage to the economy before making these changes: unemployment is already 0.7 percent higher today than it was when the recession began in 2001, and the percent unemployed for 27 weeks or more is higher than when the 2001 recession officially ended (17.5 percent vs. 13.9 percent). These changes would cost about $8 billion over 12 months. We also recommend Federal funding for modernization of state unemployment systems, including extension of benefit eligibility to low-income workers (by using each employee's most recent work history); to workers who are only available for part-time work; and to workers who leave their jobs for compelling family reasons.

[3] See BBC News, "Recession in the U.S. has arrived", January 8, 2008, at *http://news.bbc.co.uk/2/hi/business/7176255.stm*

State fiscal relief

During times of recession, state budgets are hit particularly hard. Reductions in tax receipts and cyclical increases in state spending put pressure on budgets—and since most states have balanced budget requirements, they are forced to either reduce spending or increase taxes in times of decreased economic activity. These actions perversely add to economic troubles by decreasing the total demand for goods and services, and thus intensify a recession. As such, direct Federal assistance to states can help prevent these outcomes and stimulate the economy. In the last recession, Congress provided $20 billion in aid to the states, split between general revenue sharing and a temporary increase in the Federal match for Medicaid. The same kind of assistance should be provided to the states once again, with $30 billion split equally between a general block grant and an increase in the Medicaid match.

There is mounting evidence that states are already feeling the pinch. Twenty-four states are either facing a shortfall for fiscal year 2009 or are expecting problems in the next year or two. According to the Center on Budget and Policy Priorities, just 13 of these states face a combined $23 billion shortfall.

3. INFRASTRUCTURE REPAIRS

At a time when softening demand is leading many private-sector employers to think about cutting back, public investments that create jobs directly can create demand and help break a downward economic spiral. Managed wisely, Federal investment in infrastructure can be both well-targeted and timely. America's unmet needs are enormous and growing. The state of disrepair in America's public schools, for example, is a disgrace that impedes both teaching and learning. GAO and the National Center for Education Statistics agree that deferred maintenance has created a backlog of more than $100 billion in needed repairs in U.S. public schools, and the situation worsens every year. We recommend that Congress distribute $20 billion for school repair and maintenance through existing formulas to school districts across the country.

The benefits of this ought to be obvious. School repair and maintenance work is highly labor intensive. A $20 billion investment should create about 280,000 jobs, most of them construction jobs doing roofing, electrical wiring, carpentry, painting, and masonry that would employ many of the more than 200,000 construction workers laid off over the past year—and the thousands more who will lose their jobs in the coming months as the economy stumbles. The benefit in terms of improved learning and the safety of students and teachers as schools are brought up to safety codes is reason enough to make the investment.

Those who doubt that the money would be spent well and quickly need only look at the recent experience of New York City. In 2005, New York's schools were given $1 billion to improve school buildings as the result of a court order. Within 4 months the entire $1 billion was committed to projects that were completed over the next 12 months. City officials assure us that they could easily spend another $1 billion just as quickly, and a summary of the NYC schools' several billion dollars of unfunded infrastructure needs is attached to my testimony.

State and local officials in every jurisdiction we contacted, including Michigan, Illinois, New Jersey, and California, affirm that the school maintenance needs are so well known and pressing that no time will be wasted trying to figure out what to do with the funds.

The replacement and/or repair of deficient bridges or critically important sewage treatment systems can also be timely and effective as economic stimulus. Almost every economist agrees that the Federal Reserve should act to lower interest rates, but the impact of that action won't be felt for as long as a year or more. Recent experience shows that when there is the will to get working, there is a way. Work on the I–35 bridge replacement in Minneapolis began in October 2007, just 2 months after the collapse, and is scheduled to be completed at the end of this year. Similar projects begun in mid-2008 would continue throughout 2008 and early 2009, when the job creation and economic stimulus they provide would still be badly needed, if the last recession is any predictor.

There are several key advantages of infrastructure spending as part of a stimulus package. Unlike tax rebates, all of the money will be spent and none will be saved—perhaps 50 percent or more of a tax rebate will be saved (which does not boost demand). Another advantage is that infrastructure spending has barely any leakage to imports—all the spending boosts domestic activity. In contrast, about 10 percent of consumer spending is for imports, boosting other economies not ours. Last, an advantage of spending on infrastructure relating to schools, water, bridges, and other areas is that we need to do this anyway: we get a short-term boost to demand and a long-term boost to productivity (and well-being).

The economy failed to add a single net new job until two and a half years after the 2001 recession began. The nation must do better this time, and we recommend that a total of $40 billion be spent on infrastructure maintenance, repair, and replacement to ensure a strong recovery. These are needed investments that should be accelerated to impact the economy now, when it would make the most difference.

TAX POLICY

A final word on tax policy. Tax cuts can be an effective stimulus, but only if done on a temporary and "downscale" basis. Tax reduction should be targeted to those who are most likely to spend it immediately. Low- and moderate-income taxpayers are those who will face the most immediate budget squeeze due to the recession, and thus most likely to spend any extra money received through changes in tax policy. An effective way to add a broad-based boost to consumption in order to quickly generate economic activity and job growth is to provide an immediate, one-time, refundable rebate to anyone who has paid either payroll or income taxes for 2007.[13] A total expenditure of $65 billion would yield approximately $350 or more per individual, and $700 per married couple.[14] Basing the tax rebate on payment of either payroll tax or Federal income taxes ensures that the rebate will effectively target low- and moderate-income taxpayers, many of whom do not pay Federal income taxes.

Thanks you very much for allowing me to participate in this hearing. I look forward to your questions.

NYC Schools Construction – Proposed Plan

NYC has over 1,200 public school buildings and the average age of the building is 65 years old. At least 5% of its stock was built between late 19th Century and early 20th Century (57 buildings were built between 1850 and 1900).

Additional capital resources will allow for the school building modernization, at least for the buildings built prior to 1900. Below are brief highlights of the much needed work that will help bring the schools into the current 21st Century and accommodate a safe, healthy, and technologically infused learning environment.

1. **Internal Modernization — 800 school buildings — $1.7 billion**
   - In recent years, the school system's physical plant has experienced problems associated with deferred maintenance and overcrowding in some communities
   - To provide a physically-modernized school facility that meets all building and fire code requirements and brings the DOE into compliance with Federal, State, and local mandates;

2. Technology Infrastructure — $480 million

523 school buildings	Cabling upgrade	$250 million
300 school buildings	Voice system upgrade	$120 million
475 school buildings	Wireless infrastructure upgrade	$110 million

- To upgrade the facilities to state-of-the-art technology in the schools

3. Facility Weatherization — 1000 school buildings — $2.1 billion
- To accommodate a safe, healthy learning environment throughout the year – provide heating and cooling, including replacement of the HVAC systems and windows; improve building systems to make the school facility "greener" and reaping long term effects both in terms of energy conservation and healthier learning environment

4. Physical Digital Security — 200 school buildings — $300 million
- To guarantee security within schools in order to provide a safe learning environment
- 200 large school facilities and/or campuses will need security cameras both inside and outside the school
- Based on actual projects funded under the NYCDOE capital plan, the cost is estimated a $1.5million per large school building

5. Physical Education Facility — $1.1 billion

100 middle and high school	Add new gymnasium	$400 million
100 middle and high school	Rehab existing gymnasium	$100 million
75 elementary schools	Add playground	$ 75 million
150 middle and high school	External athletic fields	$525 million

- To rejuvenate the sports programs through the rehabilitation of athletic fields and gymnasium as well as combat the obesity issues

6. Replace schools built before 1900 — 57 schools — $3.5 billion

- Would require demolition of existing facility and build the new school in the same space
- To provides appropriate space for present educational programs, relieve overcrowding, and allow to meet the needs of new educational initiatives, changes in education-related technology, and fluctuating enrollments

JANUARY 15, 2007

The Honorable HARRY REID, *Senate Majority Leader*
S–221 Capitol Building
Washington, D.C. 20510

The Honorable MITCH MCCONNELL, *Senate Minority Leader*
S–230 Capitol Building
Washington, D.C. 20510

The Honorable NANCY PELOSI, *Speaker of the House of Representatives*
H–232 Capitol Building
Washington, D.C. 20515

The Honorable JOHN A. BOEHNER, *House Minority Leader*
H–204 Capitol Building
Washington, D.C. 20515

DEAR SENATOR REID, SENATOR MCCONNELL, REPRESENTATIVE PELOSI AND REPRESENTATIVE BOEHNER: We are writing to express our strong support for prompt congressional action on economic stimulus legislation that will provide extended unemployment insurance (UI) benefits for the families and communities hard hit by the nation's distressing economic downturn and address outdated rules that limit the program's economic stimulative impact. As Mark Zandi, one of the nation's leading economic forecasters, noted after the release of the December jobs and employment report, "the economy is on the edge of a recession, if we are not already engulfed in one."

That action is needed now is obvious. Today's job market is already far weaker than it was in March 2001, when the last recession began. Then, the nation's unemployment rate was 4.3 percent, and the total number of jobless workers had grown 400,000 over the preceding 12 months. In contrast, 900,000 more workers are unemployed today compared to 1 year ago, and the latest unemployment rate (December 2007) was up significantly to 5 percent.

Unemployment is also exacting a harsher toll today as jobless workers struggle for longer periods of time to find work, and already inadequate UI benefits—on average, only $285 per week, or one-third the average weekly wage—are stretched even thinner by the rising costs of basic necessities. In December 2007, the average unemployed worker had been jobless for 16.5 weeks, compared to 12.8 weeks in March 2001. Meanwhile, gas costs ($3.10 a gallon this month) are up 80 cents from a year ago, and the cost of a gallon of residential heating oil has risen 98 cents (to $3.40) in just 1 year. USDA also predicts that food prices will experience their largest increases in years, as retailers pass on higher energy costs to consumers.

The economy's steadily worsening condition and the resulting hardship on working families demand that Congress not repeat its mistake from earlier this decade, when it waited until 3 months *after* the recession officially ended to enact the Temporary Extension of Unemployment Compensation program (TEUC). According to a major study of past Federal extensions, each dollar of unemployment insurance benefits boosts the nation's Gross Domestic Product by $2.15, while also saving over 130,000 jobs. Congress's belated response to the last recession compromised the stimulative effect of the TEUC — and another two million workers lost their jobs before the TEUC program was enacted. Indeed, the jobs market rebounded far more slowly, and more weakly, after the last recession than during any other business cycle during the past 60 years. Thus, to help prevent a similarly weak recovery, Congress should act quickly and realistically in response to the current downturn to extend and improve UI benefits.

Congress can further enhance the stimulative value of extended UI benefits by simultaneously addressing systemic UI failures that deny benefits to many jobless workers because of outdated eligibility rules that have not kept pace with the changing labor market. Only 38 percent of unemployed workers now collect UI benefits. According to the Government Accountability Office, low-wage workers are twice as likely to become unemployed, but only one-third as likely as higher wage workers to receive unemployment benefits. Over a decade ago, a bi-partisan Congressionally chartered commission recommended reforms to accommodate these concerns.

Incorporating many of the commission's recommendations, the U.S. House of Representatives recently passed legislation providing incentive grants for states to modernize their UI programs as part of the Trade and Globalization Assistance Act. A similar measure, the Unemployment Insurance Modernization Act, has strong bipartisan support in the Senate (S. 1981). Absent Congressional action to include these reforms in a stimulus package, however, substantial numbers of workers will remain ineligible for UI benefits of any sort, hurting them and the economy overall.

Accordingly, we urge Congress to adopt the following unemployment insurance policies to stimulate economic growth and help millions of jobless families regain their footing during the uncertain economic times.

- In light of the rapid rise in unemployment, a program of federally funded extended benefits should take effect without delay and it should last for at least 1 year, with states provided appropriate funding to properly administer the program.
- Recognizing the growth in long-term unemployment, jobless workers who remain unemployed after exhausting their state benefits should qualify for a maximum of 20 weeks of federally funded extended benefits. During the 1991 and 1975 recessions, when long-term unemployment was not nearly as high as it is today, Congress provided up to 26 weeks of basic extended benefits (in contrast, Congress provided only 13 weeks of extended benefits in response to the 2001 recession, and the jobs recovery was especially weak).
- Consistent with the 2002 TEUC program and most other recent Federal extensions, Congress should provide an extra 13 weeks of federally funded UI benefits to states suffering from especially high levels of unemployment.
- With costs for basic necessities (including gas and home heating fuel) reaching record levels, while average weekly UI benefits remain egregiously low (just $285 a week), Congress should also supplement Federal extended UI benefits by $50 per week.
- To help states respond effectively to the recession and provide benefits to 300,000 low-wage workers who fail to qualify for the UI program in more than half the states, the stimulus legislation should incorporate the incentive funding program of the Unemployment Insurance Modernization Act (S. 1871).

For America's working families, recent instability caused by the volatile housing, credit and oil markets has exacerbated the already severe economic strains associated with globalization and the ongoing loss of good jobs in manufacturing and other sectors. Absent quick and effective action by Congress, workers, employers and the economy overall will endure substantial hardship. Economists broadly agree that extending benefits under the nation's unemployment system is an efficient strategy to stimulate the economy, create and preserve jobs, and provide needed assistance to struggling families.

The proposals outlined above will go a long way to help the families and communities hardest hit by unemployment and prevent an even more serious recession. We urge their prompt adoption.

Respectfully submitted,

AFL–CIO, Kelly Ross, *Legislative Representative,* (202) 637–5075
American Federation of State, County and Municipal Employees
Coalition on Human Needs
Economic Policy Institute
International Association of Bridge, Structural, Ornamental and Reinforcing Iron Workers (Ironworkers)
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PREPARED STATEMENT OF WILLIAM W. BEACH, DIRECTOR, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION, WASHINGTON, DC

Senator Schumer, Congresswoman Maloney, Senator Brownback, Congressman Saxton, and members of the Joint Economic Committee of the U.S. Congress, I am William Beach, Director of the Center for Data Analysis at The Heritage Foundation. It is an exceptional pleasure to testify before you today on the state of the economy and potential efforts by Congress to alleviate financial and economic stresses. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

OVERVIEW

There is an increasingly held view that the U.S. economy is slipping into a sustained period of slow economic growth, perhaps even recession. The root of the worsening economic news is believed to be the collapsing housing sector and the financial institutions and practices that surround residential construction and mortgages. Further, it is beginning to look as though declines in housing sales, construction, and the mortgage credit industry will continue in 2008 as the mortgage default rate (principally on adjustable rate mortgages) increase. It is estimated that something above two million sub-prime adjustable rate mortgages will reset to a higher interest rate during the first few months of 2008.

The specter of further declines in home prices, more turmoil in credit markets, and the emergence of secondary, adverse effects in other parts of the economy stemming from these price and credit events has raised concern about the general economy's near-term outlook. Many analysts believe that evidence of widening economic difficulties could be seen in last month's employment report, which contained a much reduced increase in non-farm payrolls from months prior. Others see evidence of emerging macroeconomic difficulties in a relatively poor Christmas retail season and in the increasingly poor revenue results of many major state governments.

As everyone on this Committee must know, comparatively definitive evidence of a recession "near miss" or an actual recession will not be available for a long time, perhaps over a year. This slow accumulation of data renders the policymakers job particularly hard. Do policymakers rally behind an economic stimulus package that aims at avoiding a recession when we may not be heading into one at all, or do we frame a recession stimulus package that assumes we entered a period of negative growth sometime in November? Or, do we operate from the wise counsel of former CBO Director Douglas Holtz-Eakin that economic growth of positive or negative .4 percent is hardly a difference that a struggling family will appreciate.

So, just what should Congress do? As I will argue later in my testimony, Congress obviously should do nothing to harm the economy, it should let the Federal Reserve lead the effort to stabilize economic activity, and it should keep its focus on crafting long-term, pro-growth economic policy. Congress should take this moment of slow growth to do what it does best: set broad economic policy. In this instance, Congress should concentrate on signaling to investors and workers alike that its principal focus will be on improving pro-growth economic policy, mainly in the areas of tax, regulatory and pending policies. Serious work by the Congress in these areas will create greater predictability for investors and business owners and assure workers that they will have a better chance of improving their wages through increased productivity. Efforts to enhance the long-run may very well have immediate, short-run benefits as economic decisionmakers reduce the risk premium they place on starting new businesses or expanding existing enterprises.

WHAT DO WE KNOW ABOUT THE STATE OF THE ECONOMY?

While economic data generally is collected well after the fact of economic activity, current, admittedly incomplete data indicate that the economy entered a period of significantly slower growth during the fourth quarter of last year. Indeed, the data may support the argument that problems in the housing sector and related credit markets have now affected a wider array of economic sectors and interests.

The story in the mortgage industry is becoming well known and settled. Most analysts would agree that an excessive inventory of new housing faced declining demand for housing in 2006 as the Fed raised rates to reduce inflation risks. At roughly the same time, the delinquency rates for highly leveraged mortgages, principally sub-prime, began to rise, largely because many borrowers had taken payments they could not afford. Some lenders did not follow traditional underwriting practices that have been crafted to assure that borrowers have enough income to service their mortgage.

The decline in demand produced drops in new and existing home prices, which exacerbated the sub-prime delinquency rates: as home prices fell, the incentive for a sub-prime borrower to stay in a mortgage lost some of the allure that stemmed from the belief that the underlying house would continue to grow in value, thus justifying a loan that might be too great a financial burden otherwise. Further worsening the macroeconomic picture is the seemingly relentless upward trend in petroleum prices, which briefly touched $100 a barrel on futures markets this month.[1]

All of these factors have combined to make a grumpy lot out of economic forecasters. Let me give you my views.

While I continue to believe that the U.S. economy's strength and robustness are its principal characteristics, I, too, have concluded that near-term prospects are poor. For example, the probability of recession has risen in our models from 35 to 40 percent, and I could easily see little or zero growth in GDP when the fourth quarter estimates are published. The decline in residential construction will continue for some time, consumer and investment spending will slow, and growing inventories, principally in the automotive sector, will become a drag on the economy (where inventory buildup in the third quarter explains some of the large 4.9 percent growth rate).

That said, we expect GDP growth in 2008 of around 2 percent, and monthly employment growth averaging 75,000 jobs. This is slow growth, but not a recession. The reason I believe we avoid recession in 2008 is due in large part to the substantial contributions to GDP from exports. While domestic demand is expected to grow by about .9 of a percent over the next two quarters, exports are forecasted to expand by 10 percent. Recent U.S. export growth is stems from the lengthening, above trend growth in world GDP, largely due to economic strength in Europe and the long-awaited emergence of China and India to the top tier of industrial economies.

Economic policymakers need to focus on the economic trouble spots and the portions of the U.S. economy that are doing quite well. The temptation will be to see the glass as half empty. For example, now would be the wrong time to insulate the U.S. from global economic forces by restricting or regulating international trade. Moreover, now would be the wrong time (and one can't think of a right time) to Federalize private mortgage contracts or freeze contracted mortgage interest rates when the vast majority of such contracts are functioning well and when a key institutional factor to our current economic strength is the rule of law in the operation of contracts.

WHAT SHOULD CONGRESS DO?

These cautions, however, should not discourage Congress from acting to support stronger economic growth. I recommend that Congress address economic policies in three interrelated areas, all of which affect near and long-term economic performance: 1) tax policy, 2) mortgage markets regulation, and 3) long-term spending.

Nearly every significant, general slowdown in economic activity is a good time for congressional policymakers to ask, are we doing everything we can to support long-term economic growth? That is, slowdowns are good times to get back to policy fundamentals and make certain that everything Congress can do to allow the economy to grow has been done.

I am convinced the Congress is not the best policymaking body for addressing the short run challenges of the economy. That role is better played by the Federal Reserve System. So much of what Congress does is tied to the budget and appropriation processes, which take time to reach legislative results. Moreover, the Members of Congress frequently do not have the time or background for keeping up with fi-

[1] A host of commentators have given their views on the economic future, but I would direct the reader first to a very recent speech by Ben S. Bernanke, Chairman of the Federal Reserve System, on the economic outlook and recent turmoil in financial markets. See Bernanke, "Financial Markets, the Economic Outlook, and Monetary Policy," speech before Women in Housing and Finance and the Exchequer Club, Washington, D.C., January 10, 2008: *www.gederalreserve.gov/newsevents/speech/bernanke2008110a.htm* (January 11, 2008).

nancial markets, the ebb and flow of economic data, and the actions of economic institutions the way the Fed does or even the economic agencies of Federal and state governments. These institutional factors explain why congressional action often occurs after the need for action has expired, and why the actions it takes often are not as targeted as they need to be.

However, there are areas of economic policy where congressional action can by timely and targeted, though it may not intend to be short-range in focus at all. Those areas involve the reduction of investment risk.

Investors are driven, in general, by comparative rates of return when making investment decisions between various opportunities. If two business opportunities are possible, but one has a better rate of return than the other; then the investor will go with the superior opportunity . . . the one with the higher rate of return. Suppose, though, that outside factors intervene (a flood, war, regulatory changes) and this otherwise superior investment now carries more risk than the inferior one. The investor discounts the rates of return for the greater amount of risk and, if the rate of return on the first opportunity is still superior, the investor goes with that same opportunity. If, on the other hand, the risk is too great to go with the otherwise superior opportunity, the investor may take the more cautious approach of avoiding risk and placing funds in the opportunity with the otherwise lower rate of return.

Tax Policy: What can increase risk? Many factors, of course, but public policy commonly looms large. Tax increases, especially if they land on capital, increase the cost of capital and lower investment returns. When investors are uncertain about whether taxes will go up or stay the same, they still can act as though taxes have risen if they judge the risk of an increase to be nearly equal to an actual increase. And, rising uncertainty can have the effect of driving down investments in riskier undertakings.

Thus, among the first things Congress can do to address the current slowdown is to pronounce definitively on the tax increases scheduled for 2009 and 2011. There are projects, new businesses, and expansion of existing businesses that would be undertaken today if Congress signaled that taxes would be lower in 3 years. Since nearly all major capital undertakings last beyond this 3-year period, it is likely that making all or most of the Bush tax reductions permanent would stimulate economic activity today as well as in 2011.

I am probably not the only one here today who knows of businesses that are preparing now for higher taxes in 2011. They are preparing themselves by reducing their riskier projects and providing for stronger cash-flows in 2010. It is altogether possible that there are projects being canceled today that would otherwise go forward if taxes were not scheduled to rise in 2011. At times like the present, the speech of policymakers is as important as the policy actions they take. The decisions makers in business and investment are watching Washington closely to discern the direction Congress will take in responding to this crisis. If that direction includes tax increases, then investors will find more favorable economies to support and business owners will, as much as they can, locate their expanded activities in places with more favorable tax regimes.

Thus, Congress should signal today what it plans to do on taxes in 2 or 3 years. For my part, I urge the Congress to make permanent the key provisions of the 2001 and 2003 tax law changes. Maintaining lower tax rates on labor and capital income will encourage both labor and capital to work harder now when we need that greater activity.

In addition, we know from past experience that accelerating the tax depreciation of capital equipment and buildings or 1-year expensing of business purchases that otherwise would be depreciated over a longer period of time for tax purposes can help during periods of slow growth. This was certainly the record in the last slump.[2]

Demand-side stimulus (tax rebates, child tax credit, and the 10 percent tax bracket) did little to change the course of the sluggish economy. The tax rebates of 2001 did little to stimulate the economy or move it from a prolonged sluggish growth trend. Indeed, the contraction in investment and thus job creation did not begin to improve until after the 30 percent partial expensing in the 2002 act and the 50 percent partial expensing in the 2003 act, which also cut the tax rates on dividend and capital gain income. Congress has enacted depreciation and expensing stimulus plans under Republican and Democrat majorities.

Mortgage Market Regulation: Just as working on better, more pro-growth tax policy for the long run can have immediate, short-run benefits; so too can supporting long-term recovery in the mortgage and credit markets. Well functioning financial

[2] Matthew Knittel, "Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002–2004," OTA Working Paper 98 (May, 2007), Office of Tax Analysis, US Department of Treasury.

markets are central to long-term growth in jobs, incomes, and general output. Clearly, the current credit crunch points to the widespread difficulties that flow from extensive violation of traditional lending practices and excessive supplies of credit.[3]

So, what should Congress do? Four principles should be in policymakers minds when framing a policy response to this crisis.

1. *Any action should respect private property.* When lenders are faced with a high frequency of defaults, they commonly negotiate new terms with borrowers rather than face extensive defaults or delinquencies. We see these negotiations going forward now. Congress should not act in a fashion that arbitrarily abrogates or alters these contracts. It should not empower bankruptcy judges to negotiate new mortgages. It especially should not pass legislation or support administrative actions that freeze interest rates. Such actions would set a dangerous precedent of legislative interference in private contracts that could be more extensively utilized sometime in the future.

2. *Congress should not extend new subsidies to the housing sector.* An efficient mortgage credit industry is central to the country's economic future. Clearing out poorly run and unethical mortgage companies needs to happen swiftly and thoroughly, and this side of the market correction is visible everyday in the financial news. It also is important that the under- and non-performing loans be refinanced or restructured in a way that serves the long-term interests of borrowers and lenders alike. Federal subsidies to lender or borrowers would only lengthen the correction and distort the costs that the market needs to absorb and discount.

3. *Lightly reform mortgage credit regulations.* If Congress and the administration encourage the private renegotiation of at-risk, sub-prime mortgages, then the sector with the most to gain (or lose) will be resolving the sub-prime problem. Congress should review existing regulations to determine the contribution of either ambiguity in law or failure of enforcement to the turmoil in mortgage markets. It might also be good to review the administration's proposed regulations of Freddie Mac and Fannie Mae.

4. *Congressional actions should be temporary and limited.* Whatever Congress does on the regulatory side, those actions should be targeted to the problem, temporary in duration, and supportive of private resolution of the non-performing portion of the nation's mortgage portfolio.

Increase confidence in the U.S. economy by addressing long-term spending challenges. While the attention of most policymakers will be on immediate responses to the current slowdown, everyone should attend to a factor that's increasingly important to confidence in the U.S. economy: the seeming unwillingness of Congress to seriously address the enormous financial challenges from entitlement spending. Many investors and organizations that play key roles in the future of the U.S. economy are worried about long-term growth given the fiscal challenges posed by Social Security's and Medicare's unfunded liabilities. The *Financial Times* recently reported that the lead analyst for the US at Moody's warned that the credit rating agency would downgrade U.S. treasury government debt if action was not soon taken to fix entitlements.

Thus, at a time when the economy is slowing and the speech as well as the actions of Congress can affect economic activity, policymakers should take concrete steps to that will announce their intention to address unfunded liabilities in these important programs. While reforms in these programs may be beyond what this Congress's can do, it is possible to signal change by reforming the budget rules.

Currently, the Federal budget functions as a pay-as-you-go system, with a very limited forecast of obligations and supporting revenues. We just do not see in the official budget what may happen over the next 30 years. The 5 and 10-year budget windows do not permit Members or the general public to sense the obligations that are coming beyond that 10-year time horizon.

A good first step in addressing the long-term entitlement obligations of the United States would be to show these obligations in the annual budget. This could be done by amending the budget process rules to include a present-value measure of long-term entitlements. Such a measure would express in the annual budget the current dollar amount needed today to fund future obligations. Such a measure has been endorsed by a number of accounting professionals, including the Federal Accounting Standards Advisory Board.

[3] For more on what Congress should do, see David C. John and Alison Acosta Fraser, "HOPE NOW: One Step to Resolve the Subprime Mortgage Crisis", *WebMemo* no. 1742, The Heritage Foundation, December 13, 2007; and Ronal D. Utt, "H.R. 3915 Would Impose New Burdens and Limits on Moderate Income Borrowers," *WebMemo* no. 1703, The Heritage Foundation, November 14, 2007.

A solid second step would be to convert retirement entitlements into 30-year budgeted discretionary programs. Such a move recognizes that mandatory retirement funding programs for millionaires that crowd out discretionary spending programs for homeless war veterans make no sense at all. If we are to contain entitlement spending and reform the programs driving those outlays, then a paradigm shift likely will be required. Recognizing Social Security and Medicare as discretionary programs helps force attention on changes that will assure their survival well into the 21st Century.[4]

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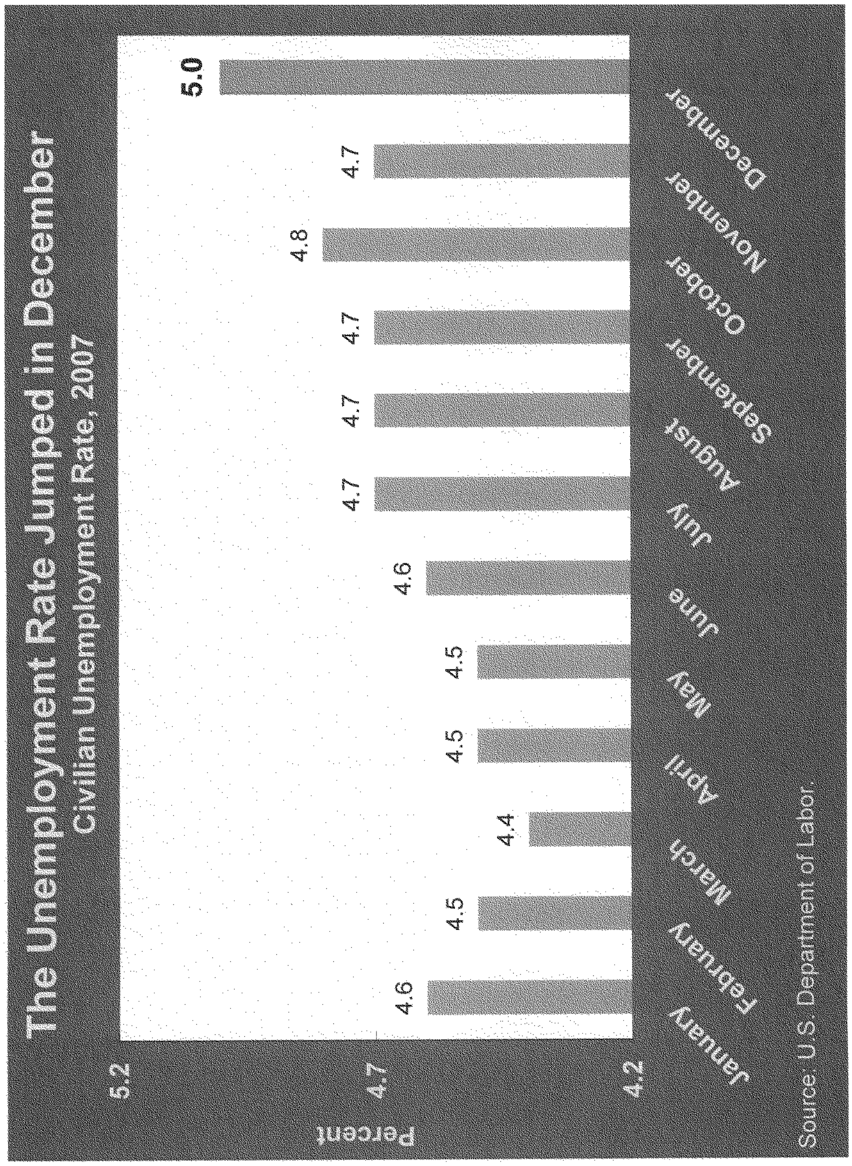
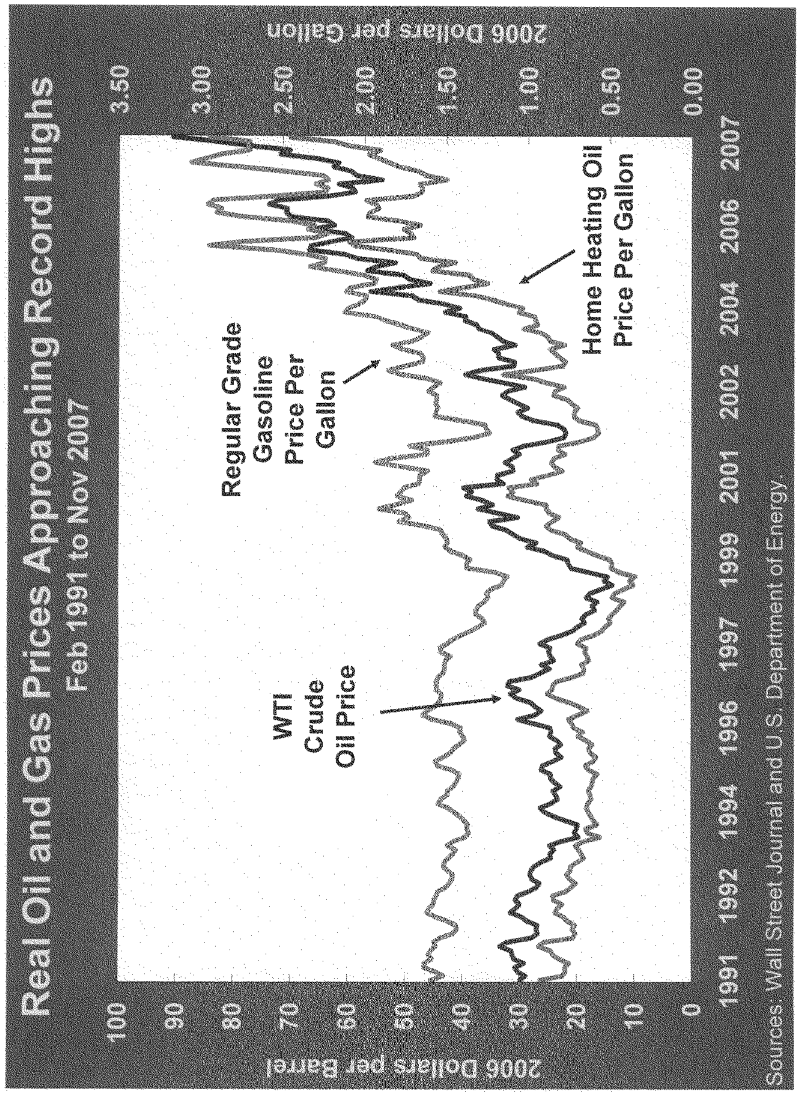
[4] See Stuart Butler, "Solutions to Our Long-Term Fiscal Challenges," Testimony before the Committee on the Budget of the U.S. Senate, January 31, 2007.


The Unemployment Rate Jumped in December
Civilian Unemployment Rate, 2007
Percent
5.2
4.7
4.2
4.6
4.5
4.4
4.5
4.5
4.6
4.7
4.7
4.7
4.8
4.7
5.0
January
February
March
April
May
June
July
August
September
October
November
December
Source: U.S. Department of Labor.


Real Oil and Gas Prices Approaching Record Highs
Feb 1991 to Nov 2007
2006 Dollars per Barrel
100
90
80
70
60
50
40
30
20
10
0
2006 Dollars per Gallon
3.50
3.00
2.50
2.00
1.50
1.00
0.50
0.00
1991
1992
1994
1996
1997
1999
2001
2002
2004
2006
2007
WTI Crude Oil Price
Regular Grade Gasoline Price Per Gallon
Home Heating Oil Price Per Gallon
Sources: Wall Street Journal and U.S. Department of Energy.