Greenspan and Tax Cuts

Washington's favorite weapons in economic policy debates are selective quotes from Federal Reserve Chairman Alan Greenspan. The quotes are plucked like arrows from a quiver and then shot at targets of the politician's choosing, not Greenspan's. A Greenspan testimony is long and varied, providing plenty of ammunition. But it is the theme of the package, not the individual lines, that is important.

The recent semi-annual testimony by the Chairman, known colloquially as Humphrey-Hawkins, is no exception. Opponents of the President's tax package seized on two particular pieces of Greenspan's wisdom, and ignored the rest. First, Greenspan urged that we delay decisions about the need for stimulus until after Iraq was settled. Since the Congressional decision-making process makes the United Nation's Security Council look like a body rushing to judgment, this note of caution hardly warranted the headlines that it got.

Second, Greenspan urged that the Congress offset the tax package with spending reductions. Opponents of the President's package view the idea of spending reductions as a non-starter. They are proposing spending increases. Since spending discipline is so out of their conceptual framework, they presumed that Greenspan's suggestion that spending cuts be coupled with the tax package meant that Greenspan was arguing against tax cuts.

The rest of the testimony showed quite the reverse. He specifically called for making the rate reductions and other parts of the 2001 package permanent, something Congressional Democrats oppose. Second, he endorsed elimination of the double taxation of dividends. Ending this punitive and growth retarding anomaly is something that Greenspan has favored for many years.

Indeed, the overall theme of the testimony was that flexible economies grow faster over the long run and recover from temporary economic shocks more quickly. It is easy to see why the President's opponents chose to ignore this message. It means that new commitments to large open-ended entitlement programs are doubly unsound. They make the economy less flexible and they create enormous future fiscal challenges. Expanded unemployment coverage makes our labor markets less flexible while driving up the deficit. Lump sum checks, unrelated to tax rate reductions, drive up public borrowing while leaving the disincentives of the tax system unchanged. The same is true for massive transfers from federal coffers to the states. These budget busting and efficiency crushing ideas form the core of the political alternatives to the President's program.

It is no surprise that politicians do not share the views of central bankers. Greenspan could have pointed to the political choices made by Japan and Europe, generally against the advice of their central bankers, for contemporary evidence of how not to promote economic growth. Japanese politicians opted for national transfers to local governments to fund public works. European politicians chose to expand social programs and expand unemployment coverage. Neither economy grew and both economies are viewed as far more structurally rigid and less able to handle economic shocks than is America.

Greenspan could not have been clearer that *if* the Congress is going to do something to help the economy, it should follow a pro-growth structure such as the one laid down by the President and not by his opponents. Even better, in Greenspan's view, Congress should enact the efficiency-enhancing components of the President's plan and undo some of the less efficient government policies on the spending side.

However desirable a policy it may be, as a political matter the Congress is not going to offset the budgetary effects of the President's proposed tax cuts on the spending side. Given that, should the Congress still act? The answer depends on how one weighs the risks to the economy.

The case for fiscal action is strong, if not totally conclusive. No one doubts that the American consumer has been key to the revival of the economy that followed the enactment of the tax cut in 2001. American consumers lost more than $5 trillion in wealth following the collapse of the 1990s stock market bubble. They are trying to repair their balance sheets by increasing their saving rate, a rate which collapsed to historic lows during the late 1990s. In the last two years households diverted nearly one fifth of their additional income to added saving.

The key to sustaining economic growth is for households to have sufficiently large increases in their income to both save more and to spend more. But it is clear that had it not been for fiscal policy, that would not have been possible in either 2001 or 2002. The private economy is simply not generating enough additional wages and capital income to allow households to both increase their saving and to spend enough to keep the economy growing fast enough for job growth to occur. Over the last two years, extra wages amounted to $179 billion, but personal tax cuts put $211 billion in people's pockets and extra transfer payments added $219 billion. In sum, changes in taxes and transfers from the government accounted for 60 percent of the total increase in personal income during the last two years.

Where will the additions to household income come from in the next two years that are needed to sustain the economy? This is particularly true when one considers the effects of rapidly rising energy prices on the state of household finances. Based on current trends in incomes and prices, real disposable personal income is likely to grow at only a 1 percent rate this year in the absence of the President's tax cut.

What about the corporate sector? In the last 5 years non-financial corporate businesses have witnessed an unprecedented squeeze on their profit margins. On average, the total 5 year increase in prices charged by this sector have been only 2.8 percent, less than six-tenths of a percent per year.

Over that same 5 year period, labor costs have risen 3.8 cents for each dollar of output produced. Depreciation charges have increased 1.8 cents for each dollar of output due to increased reliance on shorter-lived equipment such as computers. Increased corporate leverage means that interest payments take an added 0.9 cents out of each dollar of sales and higher taxes, other than profits taxes, take an extra 0.6 cents. All in all, costs have risen 7 percent in five years while prices charged have risen just 2.8 cents. Profit margins have been cut by one third. This profits squeeze is why new corporate investment has been lackluster. At some point it will revive, but when?

This adverse cash flow situation in the private structure is largely attributable to the bursting of the 1990s bubble. The American private sector is repairing its balance sheet. Household saving is rising, after its collapse in the 1990s. Corporate debt is gradually falling relative to sales. But this process takes time, and appropriate fiscal and monetary policies can both provide that time and create an economy that is more competitive in the long run.

Absent fiscal action, it is likely that the economy will still continue to grow, but not at a pace sufficient to prevent unemployment from rising. So, members of Congress have to make a judgment. They have four options. First, they could choose to do nothing, and hope that the resolution of geo-political uncertainties will be enough to stimulate growth and investment. Second, they could enact debt creating expansions in social programs and transfer funds to the states, along the lines of Europe and Japan. This may make things better in the short run, but it would almost certainly worsen our long term competitive posture. Third, they can pass the President's program, provide short term economic insurance while increasing long term economic growth. Or, fourth, they could follow Chairman Greenspan's advice and pass the President's program but offset it with spending reductions

Different people with different responsibilities naturally have different priorities. This leads them to promote different tactics in dealing with problems. But these tactical differences should not be confused with overall strategic objective of improving the flexibility of the economy. On this latter point, Chairman Greenspan and President Bush agree.