HOW TO HELP THE TO COMBAT RECESSION

What can be done to cushion the current decline and hasten economic recovery? The agenda for helping consumers and boosting the economy should begin with help for the poor and the unemployed.

by Thomas F. Dernburg

The contrast between volatile financial markets and the "real" economy, where production, income, and most employment are generated, is remarkable. That part of the economy resembles a huge ocean liner. It takes a lot to get it moving forward, and once moving it takes a lot to overcome the momentum to slow it down. Thus, we can be sure the recession we are now experiencing is bound to last several years, as was the case in the 1930s and, more recently, the "great recession" of the early 1980s. What then can be done to cushion the decline and hasten recovery?

Policy Instruments

The federal government has at its disposal two major instruments of stabilization policy: monetary and fiscal. Monetary policy is the province of the Federal Reserve. The Fed recently lowered the federal funds rate, the rate at which banks lend to each other, to half of one percent. This action only scratches the surface. Beyond that, the Fed can attempt to help the economy by purchasing government securities on the open market, thereby increasing the money supply: currency and checkable deposits. This action would also tend to raise the value of government securities and lower interest rates throughout the broad spectrum of debt instruments. Unfortunately, the Fed's monetary policies won't force anybody to borrow and spend. The Fed can tighten to slow inflation, but it can't effectively boost the economy. This lack of expansionary traction is like an attempt to push an object using a string.

One thing we require from the Fed is for it to avoid the mistakes of the past. Throughout much of the Federal Reserve's existence, its actions were designed to stabilize interest rates. This proved to be exceedingly damaging during the descent into depression in the early 1930s. Normally as the economy begins to decline, the demand for money and credit declines, causing interest rates to fall. The fall in interest rates is beneficial because it helps cushion the decline of spending. But when the Fed, as was said, "mops up excess liquidity" (decreases the money supply), this prevents interest rates from falling. The cushioning effect is thwarted, and the recession becomes that much worse. It is important to keep this historical episode in mind. Facing the current financial crisis, the Fed might revert to its historical obsession with interest rates and the stability of financial markets.

Fiscal policy is the other major instrument of stabilization policy. As opposed to public finance, which represents the financing of government operations, fiscal policy is the use of the federal budget (taxes and government spending) to neutralize ups and downs in the economy. Unfortunately, the federal deficit is already huge, and ill-advised bailouts and defense spending make it that much worse. Considerable opposition exists to policies that would increase the deficit. The question of whether we can afford more deficit must be addressed.

The NIA (National Income and Product Accounts) deficit is the appropriate measure of the influence of the federal budget on the economy. In the year 2000, the NIA budget showed a surplus of $189.5 billion. But by the first quarter of 2008, there was a deficit of $330.7 billion at an annual rate, which ballooned to $640 billion in the second quarter as revenues dwindled sharply. These facts imply a budget swing into deficit of about $830 billion. If we landed from outer space and knew nothing else about the economy, we would have to believe the massive swing into deficit would have produced runaway inflation. But that didn't happen. Why not?

One reason is that some of the deficit arose from military spending abroad. It's also because the trade deficit has been even larger than the federal deficit as imports, which represent displacement of domestic demand and production, have persistently exceeded exports. During the first half of 2008, the trade deficit was slightly over $700 billion at an annual rate, far more than the federal deficit of $485 billion. There will therefore be little likelihood that adding to the budget deficit will have much of an inflationary effect. Even Robert Rubin, the high priest of fiscal rectitude, agrees that, "our economy needs a large fiscal stimulus that generates substantial economic demand."

Agenda for Recovery

The history of the economic collapse begins with the bursting of the housing bubble, which was fueled by irresponsible borrowing and lending plus the absence of effective regulation. A lot has been suggested about how to ease the housing problem, but thus far there has been no effective way to prevent further declines in real estate values, foreclosures, and bankruptcies. At its peak in the fourth quarter of 2005, residential fixed investment amounted to only 5.4 percent of real GDP. If we keep throwing resources at the financial system in the interest of curing the housing slump, we will be in danger of letting the tail wag the dog.

Of far greater quantitative importance is the plight of the average consumer. Consumption accounts for more than 70 percent of GDP, so that is where considerable effort needs to be made. A consumer strike has been a key factor in the slowdown. Sharply rising gasoline prices acted to reduce the ability of consumers to purchase other things, much as a heavy excise tax would have caused such a drain. The high fuel prices afflicted the transportation industry and increased consumer prices, most notably food prices. Mountains of debt combined with stagnating incomes helped to create a crisis for consumer goods industries. As retail sales tumble, orders for merchandise decline, leading to production and employment losses throughout the economy. The employment losses, in turn, then cause further reductions in retail sales and employment in a downward spiral.

Last spring Congress enacted a "stimulus" package of rebates on 2007 income taxes. Anything constructive, such as extension of unemployment compensation and or an increase in food stamps, met with the threat of veto from President Bush, who would agree to nothing but a tax cut. It is not surprising that the stimulus checks had little effect. They were a one-time transfer that at best would provide only a temporary consumption boost and did nothing for low- income persons who paid no taxes and were not required to file 2007 tax returns. To

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make matters worse, the Treasury failed to get the checks out in a timely fashion. One-time boosts have no permanent value. It's like priming the pump when there is no water in the well.

The agenda for helping consumers and boosting the economy should begin with help for the poor and the unemployed. The food stamp program should be more generous, and the period during which unemployment compensation can be received should be lengthened. Programs for worker training need to be developed and subsidized. Taxes of modest-income families should be cut: for maximum benefit, the payroll taxes that are burdensome to both workers and employers. Reducing the employee's share will boost consumption; reducing the employer's share will lower labor costs and provide incentives to increase production and employment.

Payroll tax cuts will receive considerable opposition due to the notion that payroll taxes are needed to finance Social Security and Medicare. Critics forget that payroll taxes were increased sharply by the Reagan administration for reasons having little to do with the needs of the entitlement programs. Since then, payroll tax collections have exceeded the amounts needed to finance the programs. The large surpluses have been used by the Treasury to finance its various obligations. Social Security and Medicare have no money, just fictitious "trust funds" containing low yielding IOUs that can be redeemed only by the Treasury.

Exports of goods and services have been a growing source of strength that is not expected to last with the spread of the financial crisis and developing recessions in other countries. Declining imports will begin to offset export losses.

Nonresidential fixed investment (spending by business on plant and equipment) normally constitutes about 12 percent of GDP. But that is weakening as orders decline, eliminating the need to purchase machinery and equipment. New structures are not immediately needed because of excess capacity, but recession could be a good time to build for the future, especially if construction costs decline. Some believe reductions in taxes on profits and capital gains taxes can boost fixed investment. The payoff for such measures is likely to be negligible while low demand and excess capacity persist.

The National Conference of State Legislatures has estimated a $26 billion budget shortfall for 27 states during the first three quarters of 2008, an amount that is all but certain to rise. Most state and local governments are required by their constitutions to balance their budgets every year. But as the economy slows, tax revenues decline. The balanced-budget requirement then forces state and local governments to cut spending and find ways to augment tax receipts. These actions cause layoffs of government workers and reductions in support for public schools, roads, and other infrastructure. In addition to spending cuts, ill-advised tax increases also make the recession worse. The term "fiscal perversity of state and local governments" characterizes the procyclical behavior of these governmental units.

State and local governments clearly need federal assistance. Anticyclical revenue sharing programs, such as those introduced during the 1975 recession, should be established. Extending unemployment benefits and food stamp programs as essential emergency measures should be part of state and local assistance. The need for federal funds for infrastructure is enormously important, not only as emergency recession measures but because the country's infrastructure has been permitted to deteriorate dangerously. Roads, bridges, subways, tunnels, and schools all need help. While many such projects could outlast the recession, surely careful planning can avoid a future inflationary squeeze on resources.

The recession greatly increases the urgency of providing health insurance for the 47 million persons without it and is an ideal time to get serious about investing in the development of alternative sources of energy.

Moral Hazard

Wall Street wants a bailout; the auto industry is clamoring for one. But bailouts are not going to sell more cars and are likely to create moral hazard: the belief that if you get one bailout you can count on another at a later date. Moral hazard is an insurance policy the federal government should not provide for the simple reason that it removes the incentive for cost-cutting efficiencies and invites sloppy management. The view from here is that Congress badly needs to reconsider whether it wants to dish out $700 billion in gifts as a reward for greed and mismanagement. There are many more constructive ways to use the funds. ■

Thomas Dernburg is professor of economics emeritus at the American University and a former holder of the Chair of Excellence in Free Enterprise at Austin Peay State University.