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CONGRESSIONAL TESTIMONY

Promoting Job Creation in the U.S.

**Testimony before
The Committee on the Budget
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Chairman Conrad, Ranking Member Sessions, Members of the Senate Budget Committee, thank you for the opportunity to testify today. My name is J.D. Foster. I am the Norman B. Ture Senior Fellow in the Economics of Fiscal Policy at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The risks to the economy are great, and so the focus today on jobs and economic growth is critical. Two years after the end of the Great Recession, as the economy should be accelerating smartly, economic growth and job growth have ground to a halt. Speculation, argumentation, theorizing, and models are now irrelevant on this point – the data before us agree with the underlying message from the President’s recent jobs speech. They all attest to the simple, incontrovertible fact that the President’s stimulus policies have failed utterly and completely. I take no pleasure in pointing out this inescapable reality, nor in the fact that we predicted this policy failure two years ago. I would much rather have been wrong, and for millions of my fellow citizens to be gainfully employed in all those jobs the President promised to create.

Nor is the worst necessarily behind us. Left to our own, I believe the economy would pick up soon despite, not because of, the President’s policies. But we will not be left to our own. Europe is about to go through a cataclysmic paroxysm as it suffers the inevitable penalty of a failed monetary system. We are about to learn, once again, how important Europe is to the United States as Europe’s troubles present us with the stark reality of a certain, large, near-term and a still larger medium-term economic shock only the exact proportions of which remain uncertain.

To understand what policies might be helpful today and which harmful, it’s important to assess why the economy is not yet recovering. The fundamentals of our economy remain sound. The natural productive tendencies of America’s workers, investors, and entrepreneurs remain undiminished. The economy is poised to grow. Why, then, does it hold back?

There are, of course, the unusual headwinds, such as the follow-on effects of Japan’s devastating earthquake and tsunami. But the economy faces and overcomes such headwinds even in the best of times. Headwinds there are, to be sure, but they do not explain the economy’s lethargy.

The economy suffers from two categories of troubles. The first are structural troubles, which today primarily reflect a housing sector still in deep disequilibrium in many areas of the country. There is very little substantively that government can do to return housing markets to normal, and heaven knows Congress and the President have tried just about everything. And that is part of the problem. Government’s well-intentioned meddling has delayed and distorted the essential requirement for normalization – price discovery. On balance, these policies have set back the housing recovery by months, perhaps a year or more. There is an important lesson here.

The second category of trouble is what might be termed environmental -- not the natural environment, but the economic environment. Missing from most economics textbooks are the true animating forces of prosperity. Most relevant for our discussion is alternatively a shortage of confidence or an excess of bad uncertainty.

Those who could make the decisions and take the actions that would grow the economy lack the confidence to do so. Even today, the economy abounds in opportunities for growth. But turning potential into reality requires action, and action requires confidence—confidence in the future, confidence in the specific effects in government policy, and confidence that government can properly carry out its basic functions, like agreeing to a budget. America suffers a confidence shortage, and Washington is overwhelmingly the cause.

Confidence, in turn, is lacking because of an excess of uncertainty: Uncertainty about the future, but also uncertainty about the effects of government policies – tax policies, regulatory policies, monetary policies, trade policies.

Uncertainty is natural, of course. The future is always uncertain. But there is good uncertainty and bad uncertainty, much as there is good cholesterol and bad cholesterol. Good uncertainty, for example, presents opportunities for profit. Bad uncertainty arises largely when investors and entrepreneurs have very real questions about the consequences of government policy.

Tax policy provides a good example of bad uncertainty. The President's repeated insistence on raising taxes on high-income workers and investors slows the economy even without the policy being enacted. It does so by raising the uncertainty about the tax consequences of various actions. It does not stop all such actions, but it stops some, and therein lies the difference between growth and stagnation.

Moreover, the President's insistence is a twofer in terms of bad uncertainty. The specific is that taxpayers don't know what their tax liability will be. The general is that suggesting raising taxes on anyone in the face of high and possibly rising unemployment suggests a gross lack of understanding about how an economy works. That's a source of bad uncertainty that afflicts the entire economy, not just those threatened with higher taxes. In this environment, Congress need not enact bad policy to weaken the economy. Threats suffice to do real damage.

Guiding Principle: Do Less Harm

The federal government should adopt a very simple guiding principle for deciding what to do next. That principle is to do less harm. There is very little in terms of concrete actions government can do at this stage that would help, and a great deal of intended help that would harm, either by raising the deficit to no good effect or by creating more uncertainty and slowing the economy's natural healing process.

Do less harm means getting spending under control and thereby cutting the budget deficit. Americans are worried about spending and the deficit. That worry by itself is holding us back.

Do less harm means policymakers should stop threatening higher taxes. We can have debates about who should pay what when we're at full employment. In the meantime, this threat is debilitating.

Do less harm means stop the onslaught of new regulations. The recent pullback of the EPA's ozone regulation was a good example. Even the threat of new regulations creates bad

uncertainty for those affected, freezing them in place. Again, we can work through these regulations when Americans are back to work.

Do less harm means policymakers should stop meddling with the economy. There is almost no limit to the harm Washington can do *to* the economy in its efforts to do something *for* the economy. The patient is in recovery, slowed by the incessant proddings and procedures of Washington's policy doctors. The patient doesn't need another procedure or a new nostrum. Let it heal. Do less harm.

Keynesian Alchemy

What policies meet this criterion? Under the circumstances, very few. Consider, for example, the policy of increasing the budget deficit to spur the economy. The argument is fairly simple: the economy is underperforming; demand is too low; the government deficit is part of aggregate demand, so just increase the deficit. It's an equation. How can it be wrong?

The answer, of course, is that the economy is more complicated than this simple equation. Government borrows the money, so every deficit dollar spent by the government is a dollar less available to the private sector. The answer, in other words, is that the macroeconomic model ignores financial intermediation which is the bread and butter of financial markets.

Proponents will counter by saying that people are saving more, and corporations are sitting on mounds of cash. True, but it changes nothing. All this saving is not lying dormant in some vault or stuffed in some mattress. Ironically, even if it were, irresponsible deficit spending would surely not draw it out. On the contrary, this saving is deposited with the financial system, which then takes the resources from those who do not currently need them and makes them available to those who do need them. In terms of aggregate flows, this process works just as well today in recession as it does at full employment.

Thus, Keynesian demand-side stimulus does not help. It is fiscal alchemy. And by adding to the deficit and thus fears about the future, it surely adds to the economy's headwinds.

Infrastructure

Increased infrastructure spending, as the President and others have advocated, is an example of a double folly. To be clear, the issue here is not whether the nation needs more or less infrastructure spending. I am not expressing an opinion on that one way or another.

The issue is whether it acts as a short-term stimulus. It does not. First, assuming the additional spending was financed by additional borrowing, the policy runs afoul of the Keynesian fallacy. To be sure, once a project is underway one can point to the people working, but just as surely the borrowing that made that project possible reduced employment elsewhere.

The second folly is just as plain. Infrastructure spending on projects is capital intensive and stretches over years. It cannot, even if enacted, swiftly affect employment in the next year plus.

Payroll Tax Holiday

The irony of another payroll tax holiday to create jobs is that reducing payroll taxes would increase employment when the economy is at full employment yet cannot accelerate hiring in periods of high unemployment. The key to this irony is incidence – who bears the tax.

The payroll tax is borne by workers. It subtracts from their total compensation, leaving them less after-tax wage income. This is equally true of the “employer’s share,” because, of course, the employer has no share. The tax is all paid by the worker, but the worker unfortunately is aware of only half the tax, so extending the tax relief to the invisible part of the tax does not improve the outcome. Nor are weak labor markets the environment in which workers would gain a new ability to force employers to bear part of the tax.

Thus, a reduction in the payroll tax rate does not reduce the employer’s costs, but rather raises the worker’s after-tax wage. During periods of full employment, this means an additional supply of workers to be absorbed into the economy, thereby raising output. During periods of high unemployment, the increase in labor supply resulting from a payroll tax cut, temporary or otherwise, results in an increase in the number of unemployed workers. Thus, a policy intended to reduce the ranks of the unemployed is likely to produce an increase in the unemployment rate.

Repatriation Tax Holiday

Another policy under consideration that does not create jobs is a repatriation tax holiday. The issue here is not whether tax cuts are good or bad per se, but whether this particular tax cut would increase domestic employment and domestic jobs. Again, the answer is that it would not.

A repatriation tax holiday would result in a sizable influx of corporate profits from abroad. Tax policy does matter. Companies do respond to this extent. But no new jobs would result. The key to understanding why this policy and its undoubted influx of capital would not increase investment and jobs at home lies in the following question: Are these repatriating companies capital-constrained today?

No, they are not. These large multinational companies have enormous sums of accumulated earnings parked in the financial markets already. And those few if any that might need additional financing have ready access to the capital markets at remarkably low prices. Thus, they can meet all their financing needs out of available domestic resources. Adding to those resources will not increase the extent of their investment opportunities. Parallel to the payroll tax holiday that would increase the supply of workers without increasing the number of jobs available, the repatriation tax holiday would increase the supply of saving without increasing the range or amount of investments to which the saving could be applied.

Unemployment Benefits

Yet another ineffective or even counterproductive policy for increasing employment is extension of unemployment benefits. This policy may be defended on humanitarian grounds, but not as economic stimulus because it, too, runs afoul of the Keynesian fallacy. The extension of benefits will certainly increase the purchasing power and purchases of the recipients, but the borrowing needed to fund these benefits will with equal certainty reduce other areas of private spending.

Further, to the extent the resulting increased budget deficit adds to the depth of the bad uncertainty, it adds to this important economic headwind. And the research on the issue strongly suggests, as recent papers by both the Heritage Foundation and the Brookings Institution made clear, that extending unemployment benefits actually raises the unemployment rate.

Conclusion

In light of the ongoing high unemployment, policymakers should be keenly focused on what they can do for the economy. But they must also recognize the limitations of policy initiatives. As difficult as this may be to implement, the guiding principle should be: Do less harm.

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