Fiscal Policy Should Do Much More in Response to the Pandemic
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Thank you for the opportunity to testify. I am pleased to be back with the Budget Committee, and I am pleased that the Committee is taking up the crucial topic of the economic impact of the Covid-19 pandemic.

The pandemic is bringing complications to the lives of nearly everyone in the world, acute challenges to many people, and tragedies in some cases. I offer my deepest sympathy to all who have suffered and will suffer from the direct health effects of Covid-19 and from its terrible social and economic consequences. I also offer my deepest gratitude to all of the health care professionals, first responders, public servants, essential workers, and everyone who is helping others through this crisis and keeping our societies going.

In addition, I want to offer my heartfelt condolences to the family of George Floyd and to all who suffer from the scourge of racism in this country. We can and must create a more just society, and we can and must start now.

In my testimony today, I would like to make four principal points.

First, although the country is beginning to re-open following widespread shutdowns, a great deal of economic suffering still lies ahead of us, because bringing people back to work will take much longer than pushing them out of work. Second, although more economic suffering will inevitably occur, the extent of that suffering is not pre-ordained but depends crucially on the economic policies that are adopted. Third, more than a trillion dollars of additional fiscal support is warranted, with a focus on sustaining unemployed households, business operations, and state and local government budgets. And fourth, despite the very large amount of outstanding Treasury debt, the U.S. government has sufficient fiscal capacity to provide trillions of dollars of further stimulus if needed.

Let me elaborate on those points.

<u>First, although the country is beginning to re-open following widespread shutdowns, a great deal of economic suffering still lies ahead of us.</u> The U.S. unemployment rate was 3½ percent in February, 4½ percent in March, almost 15 percent in April, and perhaps around 20 percent in May, although we will not know the official number until this Friday. That shocking runup actually understates the true problem, because the loss of jobs has caused many people to

leave the labor force and thus not be counted in the unemployment figures. The labor force participation rate was above 63 percent in February, dropped to just above 60 percent by April, and almost certainly fell further in May. To capture both the people who have left the labor force and those who have remained in the labor force but cannot find a job, we can look at the number of people with jobs relative to the total number of adults. That employment-population ratio plunged from 61 percent in February to 51 percent in April, by far the lowest reading since at least the 1940s.

This dramatic and unprecedented loss of jobs cannot be reversed simply by declarations from public officials that people are allowed to go back to work and commerce. Such declarations can help, but only to the extent that people become confident they can go back to those activities while remaining mostly protected from Covid-19.

Gaining that confidence will require substantially more testing and contact tracing than we are currently doing, and it will require that areas that resume work and commerce do not end up with a renewed surge in Covid-19 cases, hospitalizations, and deaths. This will take time, money, and hard work by public officials and health care professionals, and it will take widespread public adherence to mask wearing, social distancing, and other protective measures. We are not at the end of the Covid-19 health crisis; we are only, to quote Winston Churchill during a different sort of war, "at the end of the beginning."

Therefore, a return to traditional levels of work, production, and spending will take years. The Congressional Budget Office projects that, under current law, the unemployment rate will still be in double-digits at the end of this year. CBO also projects that, of all the jobs that have been lost so far, only 30 percent will be restored by the fourth quarter of this year and only 60 percent will be restored by the fourth quarter of 2021.

<u>Second, although more economic suffering will inevitably occur, the extent of that suffering is not pre-ordained but depends crucially on the economic policies that are adopted.</u> Economic policies usually have significant effects on the course of recessions and recoveries, and this cycle is no exception.

During the Great Recession of a dozen years ago, federal fiscal stimulus provided a vitally important boost to economic activity in 2008 through 2010 while the aftermath of the housing and financial excesses of the preceding years was dragging the economy down. A survey of leading economists showed near-unanimity that the Recovery Act of 2009 reduced job losses and output losses relative to what would have occurred otherwise. Unfortunately, however, fiscal stimulus turned into fiscal restraint in 2011 and later, which significantly slowed the economic recovery and kept more people unemployed for longer than would have been the case if fiscal stimulus had continued. That premature tightening of federal fiscal policy was one of the most significant mistakes of economic policy in the past half-century.

I hope that policymakers do not make the same mistake again. The economic data that will be released this summer and fall will probably show substantial growth in output and employment from their troughs this spring. Indeed, the economy has fallen so far in the past few months that we might see exceptionally rapid growth during the third and fourth quarters. But we should not be fooled by rapid growth rates into believing that the economy has healed or that people's suffering is over. Even rapid growth in the second half of this year will still leave the number of unemployed Americans unacceptably high and the American economy operating way below its productive capacity.

Fiscal policy cannot fully offset people's unwillingness to come into close contact with each other, but it can sustain household incomes and business operations until health conditions improve and economic activity returns to previous levels. Sustaining households and businesses during this difficult period would not only improve people's well-being now but would increase the pace of economic recovery and put us in a better position in the long run.

Therefore, policymakers should maintain supportive policies until the unemployment rate is down close to where it was when the pandemic hit, which was below 4 percent. According to CBO's forecast, though, the unemployment rate will still be more than 8 percent at the end of <u>next</u> year under current policies. Therefore, we will need more fiscal stimulus to address the impacts of the Covid-19 pandemic until at least 2022.

<u>Third, more than a trillion dollars of additional fiscal support is warranted, with a focus on sustaining unemployed households, business operations, and state and local government budgets.</u> To their credit, economic policymakers have responded aggressively to the pandemic. The Federal Reserve System has eased the cost of credit and provided liquidity to businesses and financial-market participants. Without those actions, we might have experienced a catastrophic collapse of the financial system, and we certainly would have a much weaker economy with more Americans out of work. The Congress has enacted roughly $3 trillion of spending increases and tax cuts, and much, but not all, of that enacted amount has been distributed in the economy. Without that fiscal stimulus, Americans would have suffered much more already, and the prospects for economic recovery would be much darker.

But notwithstanding the very large amount of fiscal stimulus provided already, we should not declare "mission accomplished" for fiscal policy. Given the scale of the economic shock we are experiencing, much more fiscal support for the economy is warranted.

The expansion of unemployment insurance benefits in the CARES Act should be continued beyond the scheduled expiration at the end of July. Allowing those expanded benefits to expire would hurt families who cannot find jobs and are dependent on those benefits. However, I recommend that the extra weekly payment be reduced considerably from the current $600—to, say, $300. As the economy improves and some people find opportunities to return to work, we do not want high unemployment benefits to discourage such returns. I also recommend that you legislate now that expanded benefits will remain in place until the unemployment rate falls below 6 percent. By writing a trigger of that sort into law, you do not need to pick an end date based on uncertain economic forecasts, and you will enhance confidence that fiscal support will not be withdrawn prematurely. An even better version would leave expanded benefits in place in each state until that state's unemployment rate fell below 6 percent.

State and local governments are being hit by two large, negative financial shocks. Those governments need to spend significantly more money to provide health care to people who are sick from Covid-19 and to provide testing, contact tracing, and other public health measures. The governments are also losing significant amounts of tax revenue because of the recession and, especially, the drop in consumer spending, which lowers sales tax receipts. Because state governments operate under balanced-budget rules of various forms, this combination of greater spending needs and reduced revenue will soon force state and local governments to cut workers and to cut the provision of public services. The cuts in jobs would have negative spillover effects on local businesses and thereby further weaken the economy; the cuts in services would endanger people's health, education, and more. To avoid these serious problems, the federal government should provide substantial grants to states that are based on population, Covid-19 hospitalizations, or perhaps other factors. By calibrating aid to such external measures, the federal government would not be rewarding or penalizing states for their individual budgetary decisions.

Businesses also need substantially more support to sustain their operations. Keeping businesses afloat during this period when potential customers are unable or unwilling to turn up is crucial both for reducing suffering today and for enabling a more rapid economic recovery when health conditions improve. Therefore, as a complement to the Paycheck Protection Program and the Federal Reserve's Main Street Lending Program, I recommend that you enact direct wage subsidies for small- and medium-sized firms. With direct subsidies, firms could attest that their revenues are falling short of typical revenues and receive payments from the federal government to continue paying their workers; those attestations would be reconciled with actual revenues during the tax-filing process next year. Many businesses need grants, not just loans, because they will never make up the revenue they are losing now, they hope only to resume normal activity in the future. Such direct subsidies would preserve jobs and businesses, helping workers today and in the future.

The total amount of fiscal support that would be needed to help households, businesses, and state and local governments in the ways I have described is not clear to me. I hope you are asking the Congressional Budget Office to estimate the costs of various policies. But given the scale of the economic shock we are experiencing, the appropriate amount of additional fiscal support is certainly more than a trillion dollars.

<u>Fourth, despite the very large amount of outstanding Treasury debt, the U.S. government has sufficient fiscal capacity to provide trillions of dollars of further stimulus if needed.</u> Outstanding

Treasury debt will reach 100 percent of GDP by the fall—a higher reading than at any point in the nation's history except for a few years at the end of the Second World War. A decade ago, many economists would have predicted that letting government debt become so large relative to the size of the economy would sharply push up interest rates and significantly increase the risk of a fiscal crisis, in which investors would be unwilling to hold Treasury debt at any reasonable interest rate.

But that is not what has happened. In fact, interest rates on Treasury debt are now exceptionally low—under 1 percent for the 10-year Treasury note and under 1½ percent for the 30-year Treasury bond. These low rates are not just a result of the pandemic and current recession, but of shifts in private saving and investment that have unfolded over decades. Interest rates on Treasury debt have been declining for 30 years, and previous predictions that the downward trend would reverse—including some predictions for which I bear considerable responsibility—have proven wrong. Moreover, the downtrend in rates is not unique to the United States. Interest rates on government debt have fallen in many countries over the past few decades, notwithstanding large increases in the amount of debt that would be expected to raise rates. Among the advanced economies, 90 percent of government debt now trades at interest rates below 1 percent.

The dramatic decline in the cost of government borrowing is a sea change for fiscal policy. With much lower interest rates, outstanding debt can be much larger and interest payments will still be manageable. And with lower interest rates, the optimal amount of outstanding debt is larger—the federal government should borrow more than it would otherwise. The intuition for this research finding is the following: The economic cost of high debt that generally attracts the most attention is that the government's demand for funds crowds out private borrowers who would have used those funds for capital investment that would boost future growth. But low interest rates show that loanable funds are not very scarce and that private investments with even modest returns can be readily funded—so the government's use of borrowed funds is not very costly to society.

To be clear, I am not suggesting that debt can rise indefinitely relative to GDP, which is what would happen under current law. We will ultimately need to raise taxes and reduce spending substantially. But we can wait to do that until we have rebuilt a vibrant economy with full employment.

Thank you.