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The Honorable John Yarmuth
Chairman
Committee on the Budget
U.S. House of Representatives
204-E Cannon House Office Building
Washington, D.C. 20515

Dear Chairman Yarmuth,

Pursuant to section 301(d) of the Budget Act of 1974, I have asked the Democratic staff of the Joint Economic Committee to evaluate the state of the economy in accordance with the goals of the Employment Act of 1946. Below, I have included the staff's assessment of current economic trends and the implications of those trends for the federal budget.

Our primary recommendation is to focus on smart investments that grow the economy for future generations. Now is the time to think long-term and make investments with high social returns, like affordable child care, modern infrastructure and clean energy. Further, we should reject the indiscriminate and harmful cuts likely to be proposed by this administration following their wasteful tax cuts.

I also would like to take this opportunity express my concern about an issue of importance to many of my constituents – the $10,000 cap on State and Local Tax (SALT) deductions that was part of the Tax Cuts and Jobs Act (TCJA). Individuals and families are in the process of filing their 2018 tax returns, and too many are discovering that the Republican tax cuts left them with unanticipated new burdens. New York state officials are also finding that the tax cuts have hurt the state's ability to invest in programs that New Yorkers rely on. In putting together the FY2020 budget, I encourage the Budget Committee to consider ways that Congress can mitigate the worst effects of the TCJA.

I appreciate the opportunity to provide the Joint Economic Committee Democratic views. I look forward to reviewing the budget that your committee puts forth for consideration.

Sincerely,

Carolyn Maloney

Carolyn Maloney
Vice Chair
Joint Economic Committee

Assessment of Economy as it Pertains to the Federal Budget

The Budget Act of 1974 instructs the Joint Economic Committee to provide recommendations to the Budget Committee “as to the fiscal policy appropriate to the goals of the Employment Act of 1946.” The goals set forth in the Employment Act are to ensure that there are jobs available to all who are “able, willing and seeking to work” and to “promote maximum employment, production and purchasing power.” Below are the recommendations of the Democratic staff of the Joint Economic Committee in accordance with these goals.

Current state of the economy

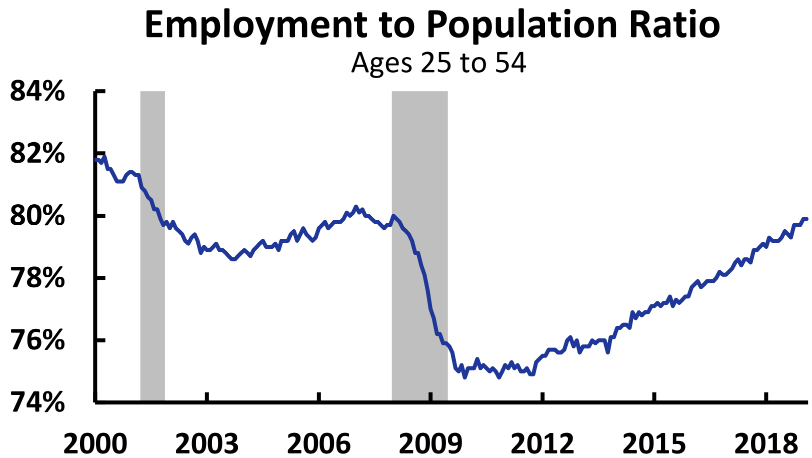
After a steady nine-year long recovery, the economy appears to be a strong position from a cyclical standpoint. The economy has added jobs for 101 consecutive months, and unemployment stands at 3.8 percent. With the tighter labor market, wages are finally starting to grow faster, although they still have room to rise after decades of low growth, and workers are coming off the sidelines and back into the labor force. This has led many economists to conjecture that the economy is near full employment. At the same time, inflation remains just below the Federal Reserve’s target of 2 percent and interest rates are relatively low.

Progress toward full employment

Full employment is a term used by economists to denote when employment reaches a level where further expansion leads to rising inflation. Considering whether the economy is at this level requires evaluating a range of economic indicators. The most common is the unemployment rate, which has remained at or below 4 percent since March 2018. Despite this low level, the economy continues to add jobs at a robust pace – adding an average of 209,000 jobs per month over the last 12 months, similar to the pace over the preceding several years.

Understanding how the economy can continue to add so many jobs despite the low level of unemployment requires looking at other indicators. Labor force participation (LFPR) fell from a pre-Great Recession level of around 66 percent to a low of 62.4 percent in 2015. Recently, this rate has started ticking back up – showing that tighter labor markets are attracting workers back into the labor force. The aging of the labor force drove part of this decline in LFPR, so we cannot expect participation to completely reach its prerecession level.

The employment to population (EPOP) ratio of prime-aged workers (ages 25 to 54) may be a better measure of full employment. This measure is just starting to get to its prerecession level – it stood at just above 80 percent prior to the recession and has risen back to 79.9 percent in February 2019. Although EPOP is at nearly precession levels, determining the specific level of true full employment is an endeavor best suited for post-hoc analysis.

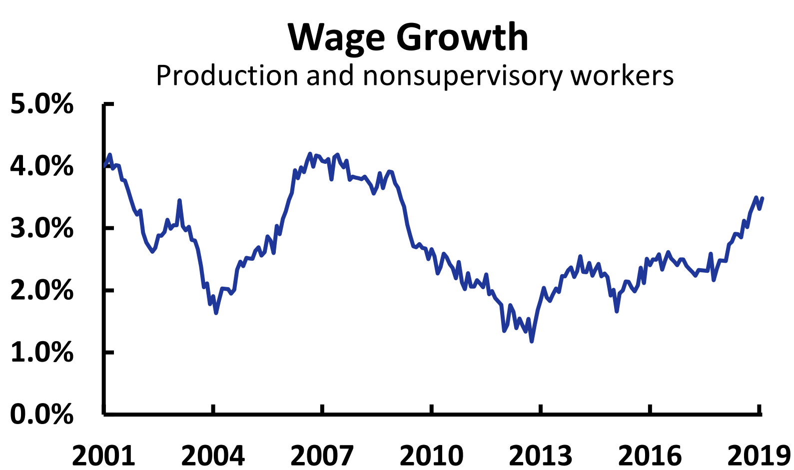


Source: St Louis Federal Reserve

It is important to note that even at levels economists consider full employment, there are people on the sidelines of the workforce who would benefit from jobs. Often, these individuals face high barriers to work, such as disabilities, opioid addictions or substantial caregiving responsibilities. A tight labor market may lead to jobs for some of these individuals, but not all. Addressing these structural barriers to work should always be a priority for Congress.

Wage growth

With a tighter labor market, employers must bid against each other for qualified workers and workers feel more empowered to demand raises or leave jobs for better paying ones. The economy started to experience this in 2018, as wage growth for production and nonsupervisory workers started to rise above the pace of inflation. There is still room for wages to continue to grow, as the level of year-over-year wage growth remains below its prerecession level.



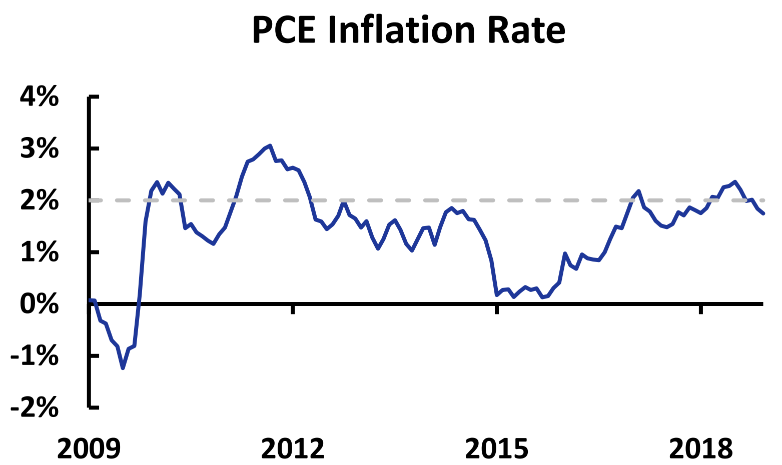
Source: Bureau of Labor Statistics

Note: Shows average hourly year-over-year growth, seasonally adjusted

Maintaining full employment for as long as possible should be a priority for all policymakers. Full employment creates an environment where workers at all levels can leverage opportunities to increase their earnings, and where employers are more willing to hire and train individuals with high barriers to employment.

Inflation and the Federal Reserve

Inflation remains low, despite the tightening labor market and rising wages. The Federal Reserve monitors the PCE inflation index – which measures the change in prices of goods and services – with a target of a 2 percent annual pace of inflation. The index has remained around or below that level for most of the recovery, and currently stands at 1.7 percent year-over-year growth. Forward-looking inflation expectations remain modest as well.



Source: Bureau of Economic Analysis
Note: the grey line represents the Federal Reserve's 2 percent target rate

In response to the tightening labor market, the Fed raised the federal funds rate four times in 2018, on top of five hikes over the previous three years. Although the Fed's estimates suggest that we are still below the neutral rate of interest and experiencing unemployment below the long-term natural rate, inflation remains low. Fed Chair Jerome Powell has recognized the uncertainty in current estimates, pledging that policy will be data-dependent moving forward. Analysts expect the pace of rate hikes to slow in 2019. Further, the Fed has been engaging in reducing the size of its balance sheet, but has stated that they will stop short of reaching their prerecession level.

Impact of the Republican tax cuts

The most significant fiscal policy enacted last Congress was the Republican Tax Cuts and Jobs Act (TCJA). Since enactment of the TCJA, the economy experienced a small temporary stimulus, which already appears to be waning. The promised investment boom – which Republicans claimed would fuel long-term growth – has failed to materialize. One common measure of expected investment, new orders for nondefense capital goods excluding aircraft, fell in four of the last five months of 2018. A survey of business economists found that 84 percent reported no change to their firms' hiring or investment plans because of the tax cuts.

To partially offset the projected $1.9 trillion cost of the tax cuts, the TCJA enacted a cap on state and local tax deductions. This cap may result in higher taxes for some middle-class families, particularly those who live in high cost of living areas but also are not wealthy enough to benefit from some of the other provisions of the TCJA. Further, the cap inhibits state and local governments' ability to raise the revenue necessary to invest in areas like education, infrastructure and health care.

The failure of the tax cuts to drive private sector investment and the added pressure the law puts on state and local investment means that the Budget Committee should not expect robust tax cut-driven growth in the near future. The Congressional Budget Office (CBO) projects that the sugar high of the tax cuts will wear off shortly and the economy will return to its long-term trend of growth below 2 percent by 2020. Further, it increases the pressure on the federal government to make the productivity-boosting investments that the economy needs.

The impact of deficits and debt

Traditional economic models suggest that the public sector should expand deficits when the economy enters a downturn, and decrease deficits as the economy improves. This is because government spending has the ability to boost aggregate demand as long as workers who want a job remain unemployed. Once the economy reaches its maximum productive capacity, deficits are traditionally thought to crowd out private investment as the government pushes the interest rate above its "natural" level to compete with other borrowers for loanable funds.

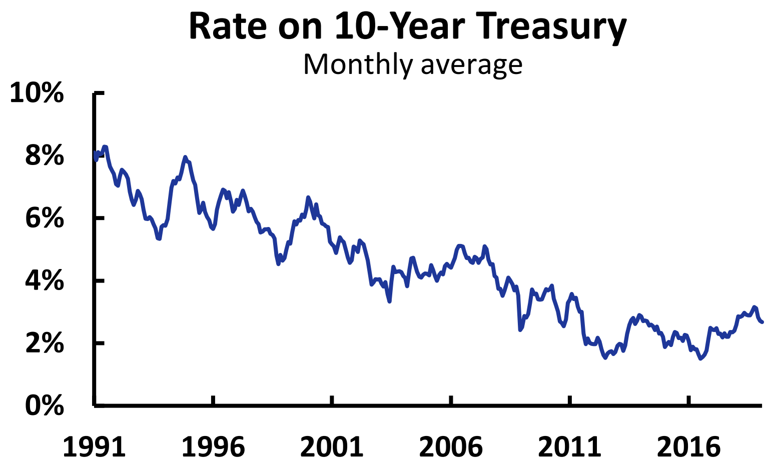
Economists have tended to emphasize the risks of chronic over borrowing, but recent research, as well as the sudden and traumatic fiscal consolidations experienced by several European countries during their recent fiscal crisis, have caused some prominent voices to warn against the opposite extreme of prioritizing budget surpluses over necessary public spending. In his presidential address this year to the American Economic Association, former International Monetary Fund chief economist Olivier Blanchard pointed out that when the interest rate on government borrowing is below the growth rate of the economy, then the government can roll over its debt while still watching it shrink as a fraction of gross domestic product. Perhaps surprisingly, the U.S. government has found itself in this position more often than not in every recent decade except the 1980s.

Former Treasury Secretary Lawrence Summers, and former Council of Economic Advisers Chair Jason Furman have expressed doubt that current deficits are negatively affecting the economy and suggested that low interest rates imply that we should focus more on sustaining future growth through sound public investments than on eliminating short-term deficits. Summers also has urged policymakers to consider the infrastructure debt we pass along to the next generation when we fail to make and maintain critical investments.

Interest rates

There remains the question of why interest rates on U.S. government debt are still so low, despite unprecedented current and projected debt levels.

Interest rates have dropped considerably over the last several decades. Although they have risen somewhat over the last couple of years, the interest rates on various U.S. debt maturities remain low relative to historical norms. The interest on a 10-year Treasury bill, for instance, is roughly half its prerecession level.



Source: St Louis Federal Reserve

There are likely multiple pressures pushing interest rates down even as the economy recovers. An aging population and slow productivity growth are likely contributors, as well as increasing foreign demand for U.S. debt. A former Obama administration economist recently pointed out that these factors are likely outweighing the rising deficit and keeping overall interest rates low. These trends are projected to continue into the near future.

Long-term debt concerns

Domestic and international demand for U.S. debt seems to be strong enough that we can borrow more, and more cheaply, than we had previously thought. This added fiscal space presents opportunities, but depends on the confidence of our creditors in the future of the American economy and the sound management of government finances. Sound management requires us to take a long-term perspective of both the growth of our debt and our economy.

Projections of long-run cost growth need to be analyzed and understood before they are acted on. CBO Director Keith Hall and Federal Reserve Chair Powell have both said this year that projections of dramatic federal spending increases are largely driven by population aging and health care cost inflation. Cutting benefits, other mandatory programs or discretionary spending instead of targeting health care cost inflation would inflict unnecessary harm on people and the economy without addressing the underlying problem.

Implications for fiscal policy

Considering the state of the economy and drawing on recent economic research, the committee staff recommends that the Budget Committee focus on long-term investments that grow the economy and long-term debt stability, rather than short-term deficit reduction.

Low interest rates and a strong labor market mean that now is the time for Congress to think about the future and make investments that address structural concerns and grow the economy in the long run. This includes investing in productivity-boosting policies like upgrading the nation's infrastructure, making education more accessible and affordable, and boosting federal research and development efforts. It also includes policies that enable all Americans to join the labor force, such as in expanding access to affordable child care that enables parents to succeed in the workforce. Addressing long-term economic threats, such as climate change and rising income and wealth inequality, should be priorities for the Budget Committee as well.

With interest rates at low levels and the economy steadily growing, now is the right time to make smart investments. At the same time, evidence suggests that higher levels of debt have economic consequences in the long run. To this end, the committee suggests that the Budget Committee avoids calls for cuts to programs with high returns on investment in the name of deficit reduction, as the president's budget is reported to do. Simultaneously, the committee recommends thinking about how to raise enough revenue in the long run to support the programs that American families rely on.

One-time investments that take advantage of low interest rates to boost long-run economic growth can be worth adding to the debt, and can even decrease the debt-to-GDP ratio in the future. On the other hand, cutting taxes for favored political groups is an unproductive use of debt and simply burdens future generations.