CBO TESTIMONY

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Subcommittee on Human Resources and Intergovernmental Relations
Committee on Government Operations
U. S. House of Representatives

February 6, 1992

NOTICE

This statement is not available for public release until it is delivered at 12:00 noon (EST), Thursday, February 6, 1992.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to discuss the possible consequences of enacting a $15 billion increase in federal grants to local governments through an amended version of the Local Partnership Act that was placed before the Congress last year. As you requested, I will focus my discussion on the proposal to provide $15 billion to local governments rather than on the entire act.

The proposal is perhaps too small by itself to make a significant impact on the pace of recovery in the overall economy, especially if its budgetary effects are offset by cuts in other programs. If it is allowed to increase the deficit and is combined with other stimulative programs, however, such a measure could speed help to hard-pressed local governments and bolster the economic recovery late this year and next.

THE PROPOSAL

The proposal would authorize appropriating $15 billion of federal funds in fiscal year 1992 for 39,000 local governments to enable them to rehire laid-off workers, restore services, or expand programs that are overburdened because of the recession. The funds would go to units of general local government according to formulas based on population, tax effort, per capita income, and unemployment. The money would have to be used for education, public

safety, health, social services such as emergency food and shelter, and environmental services. Any of the money that the local governments do not spend within a year would have to be returned to the Treasury, though in practice it may be difficult to enforce this provision.

THE ECONOMIC ENVIRONMENT

One of the main motivations for short-term budgetary measures such as this one is to bring new life to the troubled national economy. The current economic downturn has been unexpectedly severe and prolonged. Far from being the relatively mild slowdown that most economists expected to end last summer, the recessionary environment now seems likely to continue through the first quarter of 1992. The Congressional Budget Office's (CBO's) new economic forecast holds that an upturn is likely to take place only in the spring and that even then it will be anemic by historical standards.

A variety of economic problems threatens to hold back the pace at which the nation rebuilds its prosperity. These factors include the overbuilding of commercial real estate that occurred during the 1980s, which is dampening new construction now. In addition, growth in employment and incomes is likely to be hindered by the shift toward a leaner operation that

is under way in several major industries as businesses strive to improve their ability to compete in the world economy. The financial fragility that plagues many banks, and the continuing budget problems of state and local governments, will hold back growth in certain areas. In the first year or two of a normal recovery, gross domestic product (GDP) might be expected to grow at a rate of 6 percent or more, but CBO now forecasts that the economy will grow at a rate of only 2.8 percent this year.

That delayed and slow recovery means that the hardships that now beset many Americans as a result of the recession will ease only slowly. Unemployment will fall only slightly below 7 percent of the labor force by the end of 1992, and will average nearly that level for the year as a whole. Since employment and incomes are likely to recover sluggishly, the finances of households will remain under the heavy restrictions of recent months, and budgetary woes will linger among state and local governments.

Under these conditions, many policymakers are understandably eager to bring new fiscal weapons onto the economic battlefield. Until now, the nation has relied primarily on the Federal Reserve's monetary policy to end the downturn. The central bank began reducing interest rates significantly even before the recession started, most recently cutting both the federal funds rate and the discount rate sharply at the end of last year. Although these

measures finally seem to be arousing a few signs of economic life, several more months will probably pass before the recovery begins in earnest.

FISCAL MEASURES

Unfortunately, fiscal measures intended to strengthen the short-term outlook labor under unusual handicaps. One hindrance stems from the lateness of the hour. It inevitably takes months for new measures to be enacted and for their effects on the economy to be felt. Beginning the process this late in the downturn makes it highly likely that the economic effects would not be felt until the most urgent need has passed and the recovery is well under way. If their budgetary impacts are not offset through cuts in other spending or tax increases, however, new measures could add steam to the weak recovery and could bolster economic conditions in regions of the country that might otherwise be left behind. Moreover, the new measures could help ensure that the recovery does not falter late this year or next and fall into a new downturn.

A second handicap that plagues fiscal efforts to stimulate the economy is that such measures need to avoid making the already gloomy long-term outlook for the federal deficit any worse than it is. In order to have more

than a trifling effect on the massive economy, budget policies aimed at hastening the recovery would have to increase the deficit significantly. Instead, however, many measures that are now under consideration would avoid increasing the deficit altogether by raising other taxes or cutting other spending, just as the Budget Enforcement Act requires. These offsetting budgetary measures make it unlikely, however, that the overall policy could have a significant net impact on the economy. Whatever stimulus new tax or spending provisions would gain would quickly be lost as reductions in other programs depress the economy.

IMPACTS OF THE PROPOSAL

The proposal to provide new funds to local governmental units through the Local Partnership Act is a promising approach to overcoming the obstacles that stand in the way of efforts to brighten the economic outlook. The proposal's main virtue is that it could get new funds into the hands of those who need them faster than other proposals might and that the recipients might well spend the funds in time to add muscle to the economic recovery late this year and next.

The funds that the act would authorize could be disbursed promptly after they are appropriated. If all appropriations are enacted by April 1, much of the money could reach local governments before the end of this fiscal year. Based on the proposal's requirement that funds be disbursed in installments, CBO's preliminary estimates show that about 50 percent of the funds would be disbursed before September 30, and the remainder before April 1993. If the legislation instead specified that funds should be disbursed in one payment, CBO believes that nearly all of the $15 billion could reach local governments before the end of this fiscal year. These estimates are consistent with experience in 1976 under the Antirecession Fiscal Assistance (ARFA) program.

In addition to the virtue of speed, the proposed authorization of an extra $15 billion in grants is preferable to many other budgetary measures to stimulate the economy because its effects on the federal deficit could be temporary. Although the language of the proposal is not yet definitive in this regard, the sponsors have suggested that they intend to authorize these funds this year only. If the Congress carries through with this objective, the measure could aid local governments during their period of greatest need without damaging the nation's long-term prospects through a persistent new drain on our chronically low saving rate.

Dollar for dollar, the funds should have a relatively strong economic impact because of the dire needs of many local governments. Unless they receive assistance, some local governments might simply continue with tax increases and spending cuts that would weaken the economic recovery even more. The proposal could channel much-needed funds to governments that this recession has hit especially hard, since it would direct funds to jurisdictions with relatively high rates of unemployment, low per capita incomes, and strong tax efforts. The extra money could help them maintain or restore services that they could not otherwise afford. Moreover, experience suggests that, once local governments receive the funds, they could obligate them fairly quickly.

I should note, however, that along with the Local Partnership Act's significant virtues as an economic stimulus measure, it also has some limitations. First, while the proposal's chief virtue is that of speed, it is one that might fade if the Congress does not enact the proposal within the next several weeks. Many local governments complete their own budgets for the new fiscal year early in the spring; the act can have its full effect on their decisions only if it is in place before local governments' budgets are shaped.

In addition, the proposal's virtue of speed is purchased at the cost of some inefficiency in the allocation of its funds. The new money could get into

the hands of local governmental units quickly because the act would use a formula to determine who gets the funds, rather than leaving such decisions to the political process. Still, such a formula will inevitably channel some aid to units that, for one reason or another, do not face pressing needs. Some general purpose governments that would receive funds do not carry out the functions that the proposal intends to support. At least a few others have escaped the pressures of the recession or have already taken the difficult steps that are needed to adjust to its consequences.

The program might be too small to stimulate the economy significantly by itself, though it would help if it were part of a larger package of fiscal measures. The $15 billion in grants would be less than one-quarter of one percent of GDP in 1992, according to CBO estimates. Even when so-called multiplier effects are taken into account, the impact on GDP would be no more than one-half of one percent. Based on standard rule-of-thumb calculations, this increase would translate into a decline in the unemployment rate of perhaps 0.2 percentage points, producing roughly 325,000 new jobs.

The act's stimulative impact could be even smaller if the sponsors carry through their intention to offset its budgetary impacts with cuts in spending for defense. If these offsets are made quickly, the act would not inject any

significant overall stimulus to the economy. Additional spending by localities would add to growth, but reduced defense spending would detract from it.

Another factor that could work to limit the stimulative impact of the bill is that the local governments receiving aid might substitute the added federal spending for some of their own. To the extent that they did so, the additional federal funding might give rise to reduced state and local borrowing--an outcome that would have little effect on the pace of recovery--or to reduced local taxes, which would aid the economy in the short term, but perhaps not as much as additional spending would. The extent of such substitution is virtually unlimited: the act would allow localities to use the funds for many of their main functions--activities that these governments are likely to carry out to some extent with or without federal aid.

A related concern has to do with the act's possible long-term effects in delaying the inevitable fiscal adjustments that many local governments are currently enduring. Like a number of other sectors of our economy, local governments face a long-term need to retrench. Over the past year, many have responded by undertaking painful efforts to reduce their borrowing by cutting spending and, in some cases, raising taxes. Difficult as they are, these adjustments should ultimately help the economy by putting local budgets on a more solid footing and increasing national saving.

CONCLUSIONS

Although a new revenue-sharing program is not by any means an economic panacea, it could help spur the economic recovery by getting much-needed federal help relatively quickly to a sector that has had greater demands placed on it during the recession. Such a program could heat up the relatively tepid recovery that is anticipated, and could be particularly helpful to local governments in parts of the country that have been especially hard hit in recent years. Of course, the program's impacts would be greatest if they are not offset through cuts in other programs and if the program is combined with other temporary stimulative measures.