Et Tu, Alan?

By PAUL KRUGMAN

Despite his legendary obscurity, what Alan Greenspan has to say is usually quite clear and intellectually coherent once translated into English. But his testimony last Thursday before the Senate Budget Committee was evasive and often inconsistent. It was hard to avoid the impression that Mr. Greenspan's intent was to give aid and comfort to the new administration, while retaining plausible deniability.

True, Mr. Greenspan explicitly rejected the administration's argument that we must immediately cut taxes to prevent a recession. While conceding that the economy may grow little if at all this quarter, he suggested that a recovery would probably be under way before tax cuts could have any impact. By the way, new evidence suggests that manufacturing, which suffered a nasty downturn in the last few months, has already started to rebound.

Nonetheless, the headlines were all about Mr. Greenspan's endorsement of tax cuts — something the Fed chairman must have known would happen. And when you look at the tortured logic by which Mr. Greenspan arrived at that endorsement, you have to wonder whether those headlines weren't exactly what he wanted.

His argument went as follows: given its projected surpluses over the next decade, the federal government may not only pay off its debt, but actually find itself using surplus cash to buy private assets. This could cause problems, he suggested, because it would be "difficult to insulate the government's investment decisions from political pressures." So we should engage in "pre-emptive smoothing of the glide path," which turns out to mean cutting taxes enough so that the federal government never does pay off its debt, after all.

Now I would quarrel with those surplus projections. I would also
point out that in declaring "it is far better . . . that the surpluses be lowered by tax reductions than by spending increases," Mr. Greenspan was out of bounds. Since when is it the Fed's business to say that we should have a tax cut rather than, say, a new prescription drug benefit — or for that matter a missile defense system? (Neither program is factored into those surplus projections.) Mr. Greenspan himself seemed aware that he was on shaky ground, offering the very inadequate excuse that "I speak for myself and not necessarily for the Federal Reserve."

But the really strange thing about his argument was that he seemed to ignore the fact that the main reason the federal government will one day become an investor is the buildup of assets in the hands of the Social Security and Medicare systems — and those funds must accumulate assets to prepare for the future demands of the baby-boom generation. Indeed, by all estimates even the huge projected surpluses of those trust funds will be inadequate to the task. "Certainly," Mr. Greenspan declared, "we should make sure that Social Security surpluses are large enough to meet our long-term needs." Well, I'm sorry, but you can't do that without allowing the federal government to become an investor.

So if that prospect was what was really worrying Mr. Greenspan, he should have focused on the problem of how to prevent the government's position as an investor from being abused. And there are many ways to do that — including, by the way, realistic plans for partial privatization of Social Security, which (unlike the fantasy promises of the Bush campaign) would require the federal government to ante up trillions of dollars to pay off existing obligations, solving the "problem" of excessive surpluses quite easily.

But Mr. Greenspan seemed determined to arrive at tax cuts as an answer. After dismissing the argument that we need a tax cut to fend off a recession now, and conceding that tax cuts have historically "proved difficult to implement in the time frame in which recessions have developed and ended," he waffled: "Should current economic weakness spread beyond what now seems likely, having a tax cut in place may, in fact, do noticeable good." But by the same token, if the economy is strong again by the time a tax cut goes into effect, won't that tax cut do noticeable harm? Mr. Greenspan declined to answer questions along those lines.

When a man who is usually a clear thinker ties himself in intellectual knots in order to find a way to say exactly what the new president wants to hear, it's not hard to guess what's going on. But it's not a pretty sight.
What do Medicare and the military have in common? Both are about to be betrayed in the name of tax cuts.

Start with the military. During the campaign George W. Bush warned audiences that America's military was in decline. "Not since the years before Pearl Harbor has our investment in national defense been so low as a percentage" of the gross domestic product, he declared. Strangely, if you looked at the numbers put out by his economic team, you found that he actually proposed to reduce that percentage further, spending substantially less on defense than his opponent.

Nonetheless, the military overwhelmingly supported Mr. Bush; officers thought that they had an understanding — nudge nudge, wink wink, say no more — that defense spending would quickly expand once he reached the White House. Indeed, senior officers have been telling Congress that they need a 30 percent increase in their budget. (Do they? Not my department.)

Guess again. Last week, according to newspaper reports, Mr. Bush told lawmakers that there would be "no new money this year for defense." Karen Hughes, a counselor to Mr. Bush, conceded that "we may in fact need resources" for the military — may? after all that martial rhetoric? — but made it clear that there was no rush. One officer bitterly declared, "It sounds like campaign promise No. 1 being broken."

Then there's Medicare. The Medicare system is currently running surpluses, but almost everyone agrees that the Medicare surplus, like the Social Security surplus, should not be considered available for tax cuts or new spending. The two programs both rely on taxes paid by working-age Americans to pay for benefits to current retirees, and
both face a demographic crisis as the baby boomers get older. Their current surpluses are therefore, as everyone acknowledges, a necessary, even inadequate, provision for the difficult decades ahead.

Everyone acknowledges this, except the administration, which — unlike members of its own party in Congress — refuses to rule out raiding the Medicare surplus.

But isn't the federal government awash in surpluses? Hasn't Alan Greenspan told us that our big economic problem is how to give the money away, lest politicians end up owning the stock market? If there's plenty of money for tax cuts, why won't the administration give the military at least some of what it wants and promise to keep its hand out of the Medicare cookie jar?

Because someone in the White House is aware of the truth, which is that there isn't plenty of money after all.

Here's the arithmetic: the Congressional Budget Office has projected a 10-year surplus of $5.6 trillion. (I don't believe it, but never mind.) Take the Social Security and Medicare surpluses off the table, however, and you are left with only $2.7 trillion. That may sound like a lot, but the projected cost of Mr. Bush's tax cut has also grown, for reasons that are important but too boring to explain. It would now use up around $2 trillion of that surplus.

And what's left depends on the totally unrealistic assumption that federal spending, including defense spending, will not grow at all over the next decade, despite a growing population and a growing economy. Give the military what it says it needs, and we're already well into deficit — and that doesn't include missile defense, not to mention prescription drug coverage, new education programs and all that. Oh, and what about the trillion dollars of Social Security money that Mr. Bush has proposed to spend twice?

Nonetheless, Congress is about to go into a tax-cut feeding frenzy, adding huge tax breaks for corporations to Mr. Bush's proposal. The spectacle will be distressing, but it will be over quickly. Pretty soon, quite possibly as soon as this summer, we'll be worrying about deficits, not surpluses.

Of course, some conservatives would say that's the point, that we need to starve the government to shrink it. But what the federal government actually spends its money on is retirement, health care and defense; the rest is small change. So guess what gets shrunk? And if the military elite is shocked to find that this administration considers eliminating the inheritance tax more important than providing new weapons systems, that it is more concerned with the security of estates than the security of the state — well, that's what you get when you trust in winks and nudges instead of checking the
February 7, 2001

RECKONINGS

Bums and Rushes

By PAUL KRUGMAN

"Hurry up!" say the Bush people. "We need tax cuts now! In fact, we need them yesterday!"

No, seriously. The administration has declared not only that it wants to accelerate tax cuts, but that it wants to make the cuts retroactive to the beginning of this year. Treasury Secretary Paul O'Neill has suggested that later this year he may be mailing out checks, refunding the "excess" taxes paid before those retroactive tax cuts actually become law.

Think of it as a bum's rush — an attempt to run tax-cut skeptics out of town before they have a chance to make their case. But the attempt itself is a giveaway; it shows why the tax cut Mr. Bush proposes is not what the country needs.

Let's say right away — in fact, let's make this observation retroactive to Jan. 1 — that claims that tax cuts can be accelerated without reducing our soon-to-be-gone budget surplus are disingenuous. George W. Bush's economists have always tried to hold down the headline number on tax cuts by delaying the start of the big tax breaks. The $1.3 trillion number you heard about during the campaign, which has since grown to $1.6 trillion, depended on the assumption that many of the tax breaks would phase in only very slowly. Accelerate the phase-in, and the number becomes a lot bigger.

Furthermore, early tax cuts take a larger bite out of surplus projections. That $1.6 trillion cut is really $2 trillion off the surplus, because tax cuts reduce the rate at which the government pays off its debt and therefore raise its interest payments; the earlier the cut, the larger that effect. Each dollar of tax cuts this year will actually slash about $1.80 off the 10-year surplus.
The real story, however, is not the cost of this proposal but the way it undermines the whole rationale for tax cuts tilted toward the rich.

Conservatives used to be supply-siders — they wanted tax cuts in order to increase the incentive to work hard, take risks and all that. But a retroactive tax cut, a cut in the taxes due on the income you have already earned, can't provide an incentive to earn more. Goodbye Reaganomics, hello crude demand-side Keynesianism.

And if pumping up consumer demand is the rationale for tax cuts, why must they go mainly to the very, very affluent?

If incentives are the issue, what you want to do is reduce marginal tax rates, the rates taxpayers pay on any additional income they earn. And it's hard to reduce marginal rates without giving disproportionately large tax cuts to people with high incomes. That, say conservatives, is why their tax-cut proposals always provide such large benefits to the top 1 or 2 percent of the income distribution. It's all about incentives, they claim, and it just so happens that the biggest positive impact is on the lifestyles of the rich.

But a retroactive tax cut, one that applies to income you've already earned, can't have any incentive effects; so why tilt it toward the top? If the purpose of a tax cut is simply to put more money into people's pockets, why not put it into the pockets of those who really need it? One simple proposal would be to make Mr. O'Neill's checks proportional not to income taxes but to Social Security and Medicare contributions; after all, four out of five families pay more in these payroll taxes than they do in income tax.

But Mr. Bush surely won't accept any such proposal, because the alleged need for economic stimulus is only an excuse. Senator Charles Grassley, chairman of the Finance Committee, was refreshingly frank: "If we do it earlier, I don't think we're really stimulating the economy. I think we're putting in place at an earlier time basic tax restructuring." In other words, all this talk about the need for fast tax cuts is an attempt to give skeptics the bum's rush, using panic over a short-term slowdown to hustle through long-run tax cuts that will do nothing to fight that slowdown.

It's a tactic Mr. Bush's people clearly like; they're doing the same thing on environmental policy, trying to use California's electricity crisis to hustle through a weakening of environmental protection in Alaska and elsewhere. It's up to the Democrats, and perhaps a few principled Republicans, to demonstrate that they aren't bums, and they won't be rushed.
February 11, 2001

Slicing the Salami

By PAUL KRUGMAN

The selling of George W. Bush's tax cut relies heavily on salami tactics — slicing away opposition a bit at a time. To understand how fundamentally misleading that sales pitch is, we must look at the whole salami.

Basically, there are three federal taxes on individuals. The payroll tax, which is levied at a flat rate of 15.3 percent of income up to a maximum of almost $70,000, is the main tax paid by about four out of five families. The income tax is less than 10 percent of income for most families, but it rises to around 30 percent of the income of million-dollar earners. And the inheritance tax, which applies only to estates of more than $675,000 (twice that for couples), is a tax on only the very well off: a mere 2 percent of estates pay any tax, and most of the tax is paid by a few thousand multimillion-dollar estates each year.

Now for the salami tactics.

Conservatives who decry the burden of taxes always include the payroll tax in their calculations. And when arguing for tax cuts, the administration starts with numbers that include the whole salami. Again and again we hear about that projected surplus of $5.6 trillion. You shouldn't believe that projection, but for what it's worth more than half of it (the more credible half) comes from Social Security and Medicare — programs financed by payroll taxes.

When it comes to tax cuts, however, Mr. Bush's people ignore the payroll tax — that is, they propose no cut in the tax that is most of what most families pay, while demanding a large cut in the income tax, which falls mainly on the affluent. And they want to eliminate the inheritance tax, which is overwhelmingly a tax on the downright wealthy.

By proposing to eliminate a tax that falls entirely on the rich, to cut a
tax that falls mainly on the well off, but to ignore the main tax paid by most people, the administration has made a deliberate decision to tilt tax relief strongly toward the top of the scale. Families earning $50,000 per year would on average get a tax break of about $800 annually; families earning $1 million would get about $50,000. Yes, well-off families currently pay a higher share of their income in taxes — but not that much higher. And no, it's not "class warfare" to point out that the tax cut disproportionately benefits the very, very affluent.

Now you could try to justify tax cuts tilted toward the top by claiming that a rising tide lifts all boats, and that cutting taxes on the rich will make the economy grow faster. But that is not the case that the administration is making — perhaps because given the extraordinary boom of the Clinton years, it's hard to claim that excessive taxes have been a drag on economic growth.

Instead, the administration pretends that it is offering broad tax relief for working families. Last week Treasury Secretary Paul O'Neill declared that the plan "would focus on helping those people who are close to the low-income and middle-income brackets," adding that "it would affect every American that currently pays taxes." This statement isn't technically a lie: "close to" need not actually mean "in," and "affect" need not mean that a family's taxes are actually reduced. But one has to say that Mr. O'Neill, whom the press has portrayed as a straight talker, is learning his new trade very quickly.

The pretense that this is a populist tax cut is aided by careful slicing of that salami. The Bush people love to point out that families in the lower brackets will see a greater proportional reduction in their income taxes than those in the top bracket; they hope you won't notice that the main burden on such families is not the income tax but the payroll tax, which will not be cut, and that the children of the wealthy will receive large additional tax relief from the elimination of the inheritance tax.

Those staged events with "tax families" slice the salami even thinner, carefully avoiding any reference to the major beneficiaries. The only high-income taxpayer, and the only likely inheritor of a taxable estate, ever mentioned at these events is Mr. Bush himself.

Otto von Bismarck is supposed to have declared that "people will sleep better not knowing how their sausage and politics are made." Mr. Bush no doubt agrees; he hopes that the American people won't look too closely either at the composition of the tax salami or at how he proposes to slice it.
February 14, 2001

RECKONINGS

Doing the Wrong Thing

By PAUL KRUGMAN

Three weeks ago Alan Greenspan, in his now-famous testimony to the Senate Budget Committee, gave decisive aid and comfort to the advocates of huge, irresponsible tax cuts. Rumor has it that Mr. Greenspan himself was taken aback by the feeding frenzy unleashed by that testimony, and that he is now engaged in a backdoor campaign to limit the damage. (Damage to the nation, or to himself? Good question.) The Medley Report, a newsletter on economic affairs, says that "many Congressional Democrats have heard Mr. Greenspan — or his aides — tell them that he actually favors something like $1 trillion in total tax cuts rather than $1.6 trillion."

But if those rumors are true, Mr. Greenspan's performance yesterday, in his first official testimony since he let the genie out of the bottle, was a profile in cowardice. Again and again he was offered the opportunity to say something that would help rein in runaway tax-cutting; each time he evaded the question, often replying by reading from his own previous testimony. He declared once again that he was speaking only for himself, thus granting himself leeway to pronounce on subjects far afield of his role as Federal Reserve chairman. But when pressed on the crucial question of whether the huge tax cuts that now seem inevitable are too large, he said it was inappropriate for him to comment on particular proposals.

In short, Mr. Greenspan defined the rules of the game in a way that allows him to intervene as he likes in the political debate, but to retreat behind the veil of his office whenever anyone tries to hold him accountable for the results of those interventions.
Meanwhile, he dug himself deeper into an intellectual hole. Mr. Greenspan’s argument for tax cuts goes like this: If you believe the surplus projections, within about six years the federal government will pay off all its debt to the public. Thereafter it will have to accumulate claims on the private sector — and that could lead to a politicization of the financial markets. So we must cut taxes soon to dissipate much of the projected surplus.

But does Mr. Greenspan even believe his own argument? Senator Jon Corzine asked the Fed chairman whether we ought not to take a longer view. As Mr. Corzine pointed out, just beyond that magic 10-year horizon the baby boomers will start to place immense demands on Social Security and Medicare, eventually requiring either large tax increases or large cuts in benefits. Mr. Greenspan’s reply was not to worry, that by the time the boomers started reaching 65, the Social Security system would be earning lots of interest on its accumulated assets.

Mr. Corzine should have shouted, "What assets?" The direct implication of Mr. Greenspan’s argument is that the U.S. government, whose domestic spending consists mainly of programs aimed at retirees, should not make the kind of provision for the future that would be legally required of any corporate pension fund. If the federal government as a whole is not supposed to own private assets, then the assets accumulated by the Social Security and Medicare trust funds must be matched by equal or larger debts on the part of the rest of the government; so the interest that Mr. Greenspan claimed would cushion the burden of supporting the baby boomers would in fact be purely fictitious, a matter of moving money between government accounts. And so the ultimate burden of dealing with an aging population would still fall on future taxpayers, who would have been shortchanged for the sake of a short-run tax cut.

As Mr. Corzine pointed out, there are ways (such as investing in index funds) that public entities can buy private assets without politicizing markets. Mr. Greenspan said, correctly, that such solutions are imperfect; but are they worse than a solution that involves requiring the government to stay deeply in debt in order to provide the trust funds with assets to buy?

Mr. Greenspan faced a test of character yesterday. He didn't have to admit to a mistake; to do the right thing, all he had to do was "clarify" his previous remarks. Yes, the headlines would have said "Greenspan Makes U-Turn." But isn't it worth accepting some brief personal embarrassment in order to head off a looming policy disaster that you yourself have helped create? Apparently not.
February 28, 2001

RECKONINGS

Debt and Taxes

By PAUL KRUGMAN

You're a middle-aged couple, at the peak of your earning power. You are saving in preparation for your retirement, a little more than 10 years from now. You consider paying off your mortgage early. But the bank informs you that you would face prepayment penalties. Do you (a) stick with your plan to prepare for retirement, but buy stocks and bonds instead of paying off your mortgage, or (b) say, "Oh, in that case let's forget about the future and take an expensive vacation"?

George W. Bush would apparently answer (b). For that is the essence of his latest argument for his tax cut.

Right now the federal government is running a large budget surplus; but most of that surplus comes from Social Security and Medicare, programs that rely on payroll taxes to pay benefits to retirees. Those programs must run surpluses now, while the baby boomers are still paying into them, if they are to avoid either sharp tax increases or sharp benefit cuts when the boomers retire. Both programs are, in other words, pretty much in the position of that middle-aged couple a decade or so from retirement.

Mr. Bush likes to declare that a surplus means that the government is collecting too much in taxes. But it means no such thing if the surplus is mainly a matter of preparing for the fiscal consequences of an aging population. And it is. Nonetheless, Mr. Bush's advisers continue to search for reasons that doing the responsible thing is actually a bad idea.

True, Mr. Bush insists that he will not raid the Social Security surplus. But he has conspicuously refused to make the same promise for Medicare — and has also refused to consider proposals that would make future tax cuts contingent on actual surpluses, instead of
locking them in on the basis of highly questionable projections. Why? Because if you make realistic estimates both of future spending and of the costs of Mr. Bush's proposed tax cut (which will end up being at least $2 trillion, and probably considerably more), it becomes clear that he will use up all of the Medicare surplus and make a substantial dent in the Social Security surplus too.

Oh, and Mr. Bush also proposes to divert about $600 billion of Social Security taxes into new personal accounts for younger workers. This further reduces the funds available to pay for the retirement of today's middle-aged workers.

Let's not forget that Texas is now in serious fiscal difficulty thanks to the tax cut Mr. Bush pushed through as governor — a cut that he helped sell with tricky accounting, including a supposed two-year Medicaid package that was actually only budgeted for 23 months.

All this is old hat. What's new is Mr. Bush's latest argument — that since about a third of the federal government's debt is in effect subject to early repayment penalties similar to those associated with some mortgages, it would actually be irresponsible to run a surplus large enough to pay off the national debt.

Now he's right that this may be an argument against repaying that part of the debt. But to say that it justifies dissipating the surplus in tax cuts is exactly like saying that the couple we started with, frustrated in their plan to pay off their mortgage, should give up on planning for retirement.

The responsible thing, for both the couple and the federal government, is not to give up on planning for the future; it is to make alternative investments. And if this means that the Social Security and Medicare trust funds must buy stocks and bonds from the private sector, so be it.

Some people — including, alas, Alan Greenspan — have made it seem as if any purchase of private-sector assets by the trust funds would instantly politicize the financial markets and undermine the foundations of the free-enterprise system. But that's ideology, not analysis; people who have looked seriously at the issue think that these concerns are vastly overblown. There are well-established techniques for protecting government investment accounts from political meddling, such as legal requirements that the funds buy a broad index. Are these techniques imperfect? Maybe — but who would argue that rather than running some slight risks of politicizing the markets, we should squander the money that was supposed to pay for our retirement?

Only a politician with an irresponsible tax cut to sell.
March 7, 2001

RECKONINGS

Bashing the Boomers

By PAUL KRUGMAN

Call it a "Bush trillion." It's a sum that is either much more or much less than $1 trillion — whichever is convenient — but one that George W. Bush thinks he can get away with calling "a trillion dollars" in speeches.

During the campaign Mr. Bush, to emphasize his moderation, claimed that he was matching a trillion dollars in tax cuts with a trillion dollars of new spending. In fact he proposed less than half a trillion in new programs, and now he proposes no real increase in spending at all. The tax cut, on the other hand, turns out to be $1.6 trillion, except that it's really $2 trillion once you count the interest costs. And it will be $2.5 trillion if it is accelerated, something Mr. Bush has urged but not factored into his numbers, and if a major wrinkle involving the alternative minimum tax is ironed out.

Meanwhile Mr. Bush has come up with another trillion, this time his "trillion-dollar contingency fund." It comes as no surprise that the actual number in his budget is only a bit more than $800 billion. And more than half of that consists of funds that Medicare was supposed to be setting aside for the needs of an aging population. So maybe we also need to define a "Bush contingency," as in: "Gee, people might get older, and they might have medical expenses. We can't be sure — but it could happen."

Which brings us to the question of identifying the victims.

For there will be victims. The latest line from tax-cut supporters is that this isn't really a big cut, that we can easily afford it. But if that were true, Mr. Bush would be able to justify his plans with honest accounting, and would be able to honor his own party's promises to protect the retirement trust funds. Yes, his cut is somewhat smaller as a share of G.D.P. than Ronald Reagan's.
But Mr. Reagan's tax cut was a fiscal disaster, and would have been even worse had his irresponsibility not been partly offset by increases in the payroll tax that finances Social Security and Medicare.

So who will be hurt? First, of course, the usual suspects: the poor and near-poor, who, because they pay no income tax (though they pay quite a lot in other taxes), will get nothing from the tax cut but will bear the brunt of the spending austerity that the tax cut will force. And these victims include a third of the nation's children.

But there will be other victims: middle-income baby boomers.

We keep hearing about the "typical" family that will receive a $1,600 tax cut. Now it's true that under Mr. Bush's plan a median-income family of two adults and two children under the age of 17 would get a $1,600 cut starting in 2006. Most of that, however, comes not from lower tax rates but from an increased child credit. A couple whose children are grown (or even college-age) get only $600, a widow or widower gets only $300. So for middle-income baby boomers, there just isn't much of a tax break. (You can also start to see why 88 percent of families will get less than that "typical" $1,600 break, in most cases much less.)

Needless to say, there is no comparable fine print when it comes to tax cuts for the rich.

Meanwhile, Mr. Bush has made it clear that he intends to raid the funds that were supposed to support the baby boomers in their retirement. Social Security and Medicare were expected to accumulate almost $3 trillion in reserves over the next decade, reserves that were supposed to be there for the baby boomers. But Mr. Bush proposes to divert about $1 trillion — a real trillion, not a Bush trillion — into other uses. There will be elaborate sophistry about how money diverted into individual Social Security accounts is still "in the system," about how Medicare surpluses used to finance prescription drug benefits are still part of Medicare, but the fact is that in each case the money isn't available for its intended use.

Without those reserves Medicare will be in trouble early in the next decade, Social Security a bit later. But the pressure to cut benefits will begin years before.

In an unguarded moment during the campaign Mr. Bush remarked about the future Texas fiscal situation, "I hope I'm not here to deal with it." Maybe his attitude toward the consequences of his tax cut is the same: by the time the bill comes due, he'll be gone.
March 14, 2001

RECKONINGS

After the Fall

By PAUL KRUGMAN

The first thing we do, let's kill all the spokesmen. Not really; but officials at both the White House and the Federal Reserve have been making things worse. On one side, we have Ari Fleischer et al. doing their best to spread panic, in the belief that fear sells tax cuts. On the other side, we have Fed officials offering upbeat assessments that, far from building confidence, only add to the sickening sense that the central bank doesn't get it.

Monday's plunge in the markets was driven in part by more bad corporate news. But it also reflected the market's judgment about how the economy is doing. And despite the partial recovery yesterday, the case for really dramatic interest rate cuts has gotten considerably stronger.

Right now we are in a race between the natural forces of recovery and the self-reinforcing forces of contraction. The manufacturing slump that began last year was mainly an inventory cycle: companies produced too much, and then cut back their production in an effort to get rid of the excess. If that were the whole story, the economy would soon bounce back of its own accord. But it isn't the whole story: the manufacturing slump, falling stock prices and a general climate of nervousness are undermining both consumer and business confidence.

The Fed's position has been that the natural rebound once excess inventories are worked off will outrun the decline in confidence, and that confidence too will rebound once there is a clear improvement in economic indicators. Under that scenario, the Fed wouldn't want to cut interest rates too much; cutting rates drastically in the face of merely temporary weakness would risk fueling a future inflationary boom.
But what if declining confidence wins the race? Then the decline in confidence would feed on itself. The odds are that the Fed would eventually succeed in turning things around; but a lot of damage would have been done in the meantime. And there's the small but scary possibility of a Japanese-style trap, in which even cutting rates all the way to zero turns out not to be enough.

Even a few weeks ago the Fed's sunny scenario seemed fairly plausible. But since then a drumbeat of bad news has changed the odds. Numbers on employment have held up pretty well so far, but surely they are a lagging indicator. Given the evidence that consumer spending is starting to fall, and the anecdotal evidence of canceled or postponed business investment, it's hard to avoid the sense that contractionary forces are pulling ahead in the race. And the decline in the markets both reflects growing pessimism and strengthens the case for that pessimism.

I've done a very rough calculation on what Monday's fall in stocks might do to consumer spending. This is real fuzzy math, but it suggests that one day's stock decline might well depress consumer spending more than a whole year of the new, accelerated version of the Bush tax cut would increase it. Which brings us to the question of policy.

It goes without saying that the Fed must cut interest rates next week. And too small a cut will be almost as bad as no cut at all. If confidence is not to plunge, business needs a big rate cut, one that shows that the Fed understands the gravity of the situation.

What about tax cuts? George W. Bush continues to sell his plan as a recession-fighting measure, but his plan is almost perfectly designed not to serve that function. Or as a headline in The Wall Street Journal put it, "Tax-Cut Talk Is Big; Relief Would Be Small." In order to keep down the headline cost of their plan, Mr. Bush's economists delayed most of the big tax breaks until late in the decade. And they cannot do much to accelerate those breaks without making it obvious to everyone that they are planning to raid Medicare and Social Security.

On Monday, former Treasury Secretary Robert Rubin suggested a smaller, "front-loaded" tax cut that would cost far less but would put much more money into consumers' pockets in the near term. This could help a bit more. But the ball is mainly in the Fed's court.

There are times when policy makers should be judicious, when they should resist being rushed by events. This is not one of those times.