FISCAL POLICY AND ECONOMIC RECOVERY

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As you are surely aware, a few weeks ago Congress passed and the President signed the American Recovery and Reinvestment Act of 2009. With the last-minute drama surrounding the passage and all the other things going on in the realm of economic policy, I think it is easy to lose sight of what a major accomplishment this Act represents. It is simply the biggest, boldest countercyclical fiscal stimulus in American history. One way to see this is to compare it with Franklin Roosevelt's New Deal. In the biggest year of the New Deal, 1934, the fiscal expansion was about 1½% of GDP. And this expansion was followed the very next year by a cutback of almost the same size. In contrast, the act that was just passed provides fiscal stimulus of close to 3% of GDP in each of 2009 and 2010.

Another fact that may have been lost in all the hoopla is the fact that almost all of the spending in the bill is genuine stimulus. Yes, the patch to prevent the Alternative Minimum Tax from raising taxes on millions of families, while desirable, was largely anticipated, and so may not have a large extra stimulatory effect. And, a small amount of the government investment, about 4% of the overall package according to the Congressional Budget Office, won't happen until after fiscal 2011. But, even CBO says that about 75% of the $789 billion will spend out in just the next 18 months. And this is the stuff of conventional textbook stimulus – tax cuts for 95% of families; direct aid to people hurt by the recession, through increased spending on programs like unemployment insurance and Food Stamps; checks to state and local governments so they don't cut services and raise taxes; and direct government spending on infrastructure, education, energy efficiency, and other valuable programs.

A key question that I have tried to answer, and that I'm sure that any of you who do forecasting have faced, is what we can reasonably expect this massive infusion of fiscal stimulus to do. This is a question where my current life as a policymaker and my previous life as an academic intersect. I have spent much of my academic career trying to estimate the effects of both monetary and fiscal policy. I thought I would draw on that work today to talk about the role fiscal policy is likely to play in the much needed economic recovery. In particular, I want to talk about two issues. First, what do we know about the effects of fiscal policy in general? And second, are there special factors in the current situation that may make fiscal policy more or less effective than usual?

Fiscal Policy Multipliers in General

Let me start with the issue of the effects of fiscal policy in general. If we cut taxes by 1% of GDP or increase government spending by a similar amount, what will that typically do to real GDP or employment? That is, what are the fiscal policy multipliers? I will be the first to point out that estimating these multipliers is difficult and that there is surely substantial uncertainty around any estimate. But, I feel quite confident that conventional multipliers are far more likely to be too small than too large.

David Romer and I have argued that omitted variable bias is a rampant problem in estimating the effects of fiscal policy. One good way to illustrate this is to discuss Robert Barro's approach to estimating the spending multiplier. Barro has argued that a reasonable way to estimate the effects of increases in government spending is to look at the behavior of spending and output in wartime. But, consider one of his key observations – the Korean War. If he were using just this observation, Barro would basically divide the increase in output relative to normal by the increase in government purchases relative to normal during this episode. When one does this, one gets a number less than one. From this Barro would conclude that the multiplier for government spending is less than one. But, other things were going on at this time that also affected output. Most importantly, taxes were raised dramatically; indeed, the Korean War was largely fought out of current revenues. That output nevertheless rrose substantially is evidence that the effects of increases in government spending are, in fact, very large.

In estimating the effects of the recovery package, Jared Bernstein and I used tax and spending multipliers from very conventional macroeconomic models. Indeed, many people in this room, as well as those at key government agencies, kindly provided simulations of the effects of standardized changes in taxes and government spending in their models. And, one of the things that both struck us and reassured us was that the estimates were quite similar across forecasters. In most models, a tax cut has a multiplier of roughly 1.0 after about a year and a half, and spending has a multiplier of about 1.6.

These policy multipliers are surely more accurate than the simple calculations Barro suggests because big macro models try to take into account the other factors driving output. In their estimation, what is happening to all the policy variables is considered, as well as factors such as international developments, commodity prices, and consumer sentiment. However, because it is difficult to fully control for all of these factors, and because policy inherently has a large endogenous component, the issue of omitted variables is almost surely still present and important.

For this reason, David and I proposed an alternative way of estimating the effects of tax changes[1]. We used the vast array of narrative evidence that exists on the motivation for tax actions. We read Congressional reports, Presidential speeches, the *Economic Reports of the President*, and other documents to identify tax changes that were not motivated by other factors likely to be related to the current or prospective state of the economy. To give you a sense of how we classify changes – the 1975 tax cut, which was passed to try to mitigate a recession that was expected to continue in the absence of policy actions, is inherently endogenous with respect to output and so is not an appropriate observation to consider; the Reagan tax cuts, on the other hand, which were motivated by views about the appropriate size of government and the adverse incentive effects of high marginal tax rates, are relatively exogenous and so are appropriate to use. We then looked at what happened to output following the relatively exogenous tax changes. We find that the short-run effect of a permanent tax cut of 1% of GDP is to raise output by between 2 and 3 percent over the next three years. Furthermore, the nature of the responses suggests that the short-run effects of a tax cut operate mainly through aggregate demand: unemployment falls quickly and sharply, and inflation tends to rise.

Unfortunately, doing the same kind of narrative analysis for government spending would be very difficult: there are vastly more spending changes than tax changes, and the motivations for them are less easily classified. But, the same issue of omitted variables is surely present. As the Korean War example illustrates, spending changes are often taken at the same time as tax changes that push output in the opposite direction. Also, spending increases are often taken in recessions, where other factors are clearly reducing output. As a result, it is likely that conventional estimates of spending multipliers are also biased downward.

Furthermore, there is every reason to believe that if we could do the same kind of careful study for government spending, the usual relationship between tax and spending multipliers would be maintained. That is, measured correctly, I would expect the spending multiplier to be larger than the tax multiplier. The reason is the conventional one: all of an increase in government purchases goes into spending, whereas only some fraction of a tax cut is spent.

The key conclusion of this analysis of general fiscal policy multipliers is that fiscal stimulus typically has a substantial effect. And, existing estimates are almost surely more likely to biased downward than overstated.

Fiscal Multipliers in the Current Situation

So far, I have been talking about the likely effects of fiscal expansion in general or on average. But, of course, there is much about the current situation that is not average: we are in the midst of a severe financial crisis; we are starting with a painfully large budget deficit; the downturn is already verging on historic proportions; and consumer and business confidence is severely shaken. How, if at all, are these factors likely to affect the impact of the fiscal stimulus?

Let me start with the financial crisis. A common argument is that fiscal stimulus will have less effect because financial markets are operating poorly and lending is not flowing. I want to offer a different view. I think it is possible that fiscal policy will have even more oomph in this situation. When households and businesses are liquidity-constrained by reduced lending, any money put in their pockets is more likely to be spent.

More fundamentally, there is strong reason to believe that a recovery in the real economy is salutary to the financial sector. When people are employed and buying things, loan defaults fall and asset prices are likely to rise. Both of these developments would surely be helpful to stressed financial institutions. This is, I believe, a key lesson of the Great Depression. In the Depression, the end of deflation, renewed optimism, and increased employment and output were as crucial to the recovery of the financial system as the more direct actions taken to stabilize banks. Thus, real and financial recovery reinforced each other. So, fiscal policy to raise employment may help to restart lending and in that way generate a more durable recovery.

Another unusual aspect of the current environment is the fiscal position we are starting from. The new Administration inherited a budget deficit of well over $1 trillion, and a long-run fiscal trajectory that was clearly not sustainable. How is this unfortunate situation likely to impact the effectiveness of fiscal policy?

Let me start with several reasons the initial fiscal situation does not create problems for the stimulus package. There is no reason to think the government will have any trouble doing the borrowing needed to finance the package: investors appear to be delighted to lend to the U.S. government at very low interest rates. Nor do we need to worry that lending to the government will displace other lending: the whole point of fiscal stimulus is that by borrowing money and using it to finance tax cuts and spending increases, we can stimulate economic activity and raise the total volume of lending, saving, and investment. Finally, because the stimulus package, though large, is a one-time program, the additional debt the government is taking on to finance it will have only a small effect on the long-run fiscal outlook. Indeed, by helping to prevent a long downturn and the possibility of an extended period of stagnation, it is helping to prevent an outcome that could significantly weaken our long-run fiscal prspects.

Nonetheless, we did have a concern about fiscal expansion starting from the current budget situation. Our worry was that if households and firms saw a large fiscal package unaccompanied by any commitment to addressing our fiscal challenges, their confidence might be further shaken, and the benefits of the package muted as a result. It is in part because of this belief that the long-run fiscal issues interact with the short-run ones, and in part because of the importance we attach to addressing the long-run fiscal challenges in their own right, that we chose not to wait until the short-run crisis had passed before addressing the long-run issues. Obviously, it is beyond the abilities of any Administration to reform our health-care and entitlement systems in its first hundred days. But, as the fiscal summit we held last week and, especially, the budget we released last Thursday show, we are committed to long-run fiscal discipline and are already taking concrete steps to achieve it.

A third feature of the current situation that is unusual is the severity of the downturn. A key fact about recessions is that they tend to be followed by periods of rapid growth as the economy recovers. Indeed, if periods of lower-than-normal growth were not followed by periods of higher-than-normal growth, the unemployment rate would never return to normal. Further, the historical pattern is that the deeper the recession, the more rapid the rebound. For example, consider the three largest previous postwar recessions. Following the trough of the 1957–58 recession, real GDP grew at an average annual rate of 6.2% over the next eight quarters. Following the 1974–75 recession, the figure was 4.6%. And following the 1981–82 recession, it was 4.9%.[2]

An important reason for the rebounds is that recessions are periods of low business and housing investment, low purchases of consumer durables, and declining inventories. When the economy turns around and confidence returns, the resulting pent-up demands spur rapid growth.

What this means for the current situation is that fiscal policy may have a very large effect at some point. Given how far the economy has fallen, it is clear that, sooner or later, we are going to have a period of very rapid growth as things return to normal. If the stimulus package can bring us to that time sooner, for a short while it will cause growth to be much larger than it would have been otherwise.

A final feature of the current situation that I find troubling is the remarkable collapse of consumer and business confidence. There is no doubt that businesses and consumers are severely concerned about prospects for recovery. And, if we measured uncertainty, I suspect that those numbers would be even worse. Concern over what *could* happen is almost surely greater that perceptions of what is likely to happen.

When consumers and firms are worried and uncertain about the future, it is natural to wonder if they may respond less than usual to fiscal stimulus. Consumers may save their tax cuts rather than spend them. Businesses may refuse to take advantage of investment incentives and continue to forego investment.

This concern was one reason that we designed a plan with a wide variety of elements. To have focused solely on tax cuts risked putting all of our eggs in a basket that could well be less effective than normal. In this situation, direct government investment and aid to states had the advantage of being spending we were fairly certain would stimulate demand and create jobs.

But, it is also the case that allaying consumer and business fears could be a mechanism by which the Recovery Act may have a greater impact than usual. As I mentioned at the outset, by conventional measures Roosevelt's New Deal was relatively small. But, I think there is a reason that it so large in all of our memories. For our parents and grandparents, it was a crucial break with the policy of inaction and liquidation that had characterized the horrific downward slide from 1929 to 1933. To have a President step up to the challenge and say the country would attack the Depression with the same fervor and strength it would an invading army surely lessened uncertainty and calmed fears. In that way, I believe it had a beneficial effect on consumer and business spending that cannot be captured by conventional models or estimates of fiscal policy multipliers.

In my mind, the American Recovery and Reinvestment Act, together with the financial stabilization plan and housing reforms announced over the past few weeks, may provide just such a Rooseveltian moment. We could see fiscal policy having more effect than usual by giving American consumers and producers the confidence and certainty they need to get back to spending and investing.

The bottom line is that, even with all the special challenges we face, I firmly believe that fiscal policy will have a crucial beneficial impact. Indeed, I think the unique conditions we face are likely to make fiscal policy uniquely effective. When the history of this episode is written, I believe the Recovery Act signed on February 17th will be seen as the beginning of the end of the worst recession in postwar history.

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1. Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," available at http://www.econ.berkeley.edu/~cromer/draft1108.pdf

2. Here troughs are dated by the troughs in real GDP, not the NBER troughs.