

General Discussion: Activist Fiscal Policy to Stabilize Economic Activity

Chair: Alan Bollard

Mr. Lindsey: One of the reasons the profession has confusion about multipliers is that we take at face value the value of the initial injection of government spending. This shows up in the current paper. The biggest component of the current fiscal package is transfers to state and local governments. Yet, the estimates that you cite in here all relate to taxes and to investment incentives.

There is a good reason for this. Forty years ago when we were in graduate school, there were lots of experiments with fiscal injections through state and local governments—the Johnson administration, the Nixon administration. The profession universally concluded that they were a waste of money. Therefore, we haven't done it ever since; therefore, you can't find a multiplier on them. The value of the injections is low. The Office of Management and Budget (OMB) just did a study on that in the second quarter, which would be the first quarter after the package was passed, and only eight-tenths of one percent of money obligated by OMB had been expended. So, it's a real problem when you go through the quagmire of state and local governments.

Secondly, the other lesson that we learned institutionally is you do not let the appropriators in Congress get control of the package. This is something we learned in the Budget Act of 1974, which

drastically cut back their ability to use money. Reagan and Rostenkowski cut the same deal—the Andrews Air Force Base—the Clinton 1993 package. When you give money to the appropriators, the value of the initial injection will be less than what is measured in our accounts. Therefore, you will get a much lower apparent multiplier, because a lot of the money simply leaks out in the classic leaky bucket before it even gets into the economy.

Mr. Gurria: The question is, When do we move from policy-driven recovery to self-sustained growth? Then what do we do about it? We clearly are not there yet, although the second-quarter results are obviously stimulating. We agree that the activism was warranted. We also agree that, in the case of the United States, size counts, and it counts for the whole of the world, not just for the United States.

When referring to the stimulus packages, we know that implementation has not been brilliant, but maybe that spells better for the rest of this year and next year and maybe 2011, when maybe the other stimulus packages will have lost their steam, because Europe and others cannot run this forever. And the United States will still be going. It is somewhat back-loaded, and that is not bad. It is probably better to take a little longer and get it right.

The big question, of course, is, When do you withdraw and when do you continue to stimulate? We are not suggesting another package. We agree with the authors. The elements are not there. However, there is also not a question of withdrawing the stimulus now. Our position is stimulate now, consolidate later. But give the signals today about how the consolidation will take place, because this is sorely missing in the markets. This is creating an enormous loss of confidence.

Japan's way of doing it is saying, "We are going for a primary balanced budget. But it is now going to take to 2012 or maybe 2013."

The United States is saying, "We'll halve the budget by the end of the first Obama administration." They are not very clear how but are very heavily depending on what happens with the health discussions.

Then, in the case of the U.K., they said they will put back some of the taxes they lowered. The Germans went their own way. They have

their cultural traditions. They have their fear of inflation. They said, “balance budget amendment in the Constitution.”

The question is, Is it credible? Is it not? Is it going to happen or not? They gave a loud and clear signal of commitment to the markets by saying that this is not an intergenerational problem. They are saying: “We are going to fix it in this generation. We are going to fix it by 2015 or 2016.” It may not be possible. Everybody is asking whether it is going to happen or not, but it is a very strong signal.

It is about signals. Stimulate now, consolidate later. But give very, very strong signals about how the consolidation will take place in order to get the confidence of markets about this particular issue, because it is now substituting the financial crisis in the minds of the analysts. The issue of the big deficits and the big debt is now eroding the confidence going forward.

Mr. Levy: We need to distinguish between activist fiscal policy and effective countercyclical fiscal policy. The Auerbach-Gale measure of activism is based on very traditional measures where you adjust the deficit and divide by GDP. But we all know that lump-sum payments are very different than government infrastructure spending. We know temporary tax reductions are very different in character and their presumed economic effects than permanent tax cuts. An area for future research would be, even though we all know there is a band of uncertainty around these multipliers, we need to focus much more on the components of a fiscal package of the activism—distinguished not just between spending and taxing, but the components and the allocative effects of those components—and handicap new measures of fiscal policy, so that prospectively we could articulate that to the public.

Here I'd like to bring out the point that President Bush's tax rebates last year and some of the lump-sum payments this year—the economic literature told us that it would have a very small impact on spending. Why don't we just tell the public, if that is what we are going to purpose, that we are basically substituting government debt for private debt? But we need to come up with new measures of fiscal

stimulus, despite the uncertainty, that reflect our best knowledge of what the most effective countercyclical fiscal policy would be.

The second point I would like to make is with regard to the long term. If you look at the last handful of U.S. recessions, the deficit rose to about 5 percent of GDP, at the extremes. Now, we all know the deficit is more than 10 percent of GDP this year. That's a fact of life, given the severity of the recession and the financial stress. But, if we look at the long-term projections and the 10-year proposals by the Obama administration, even when you return to full employment and full potential in the economy, the deficits are still 4 to 5 percent of GDP, as measured by the Congressional Budget Office.

Now, Glenn Hubbard brings out the point that, if people perceive the exit policy from this unsustainable trend is higher taxes, it will dampen current spending and impact of the multipliers. But I would also like to emphasize, just as we talk a lot about the credibility of monetary policy, the fiscal authorities can gain credibility only if they adopt policies that are sustainable and fiscally responsible.

Mr. Meltzer: It's very interesting that 70 years after Keynes wrote—probably 75 years since Richard Kahn explained the multiplier to him—we still don't know how big the multiplier is. Years ago, when I used to teach macroeconomics regularly, I used Martin Bailey's book. Jim Tobin once assured me it was a surprising thing that the best book of Keynesian macroeconomics was written at Chicago. But Martin Bailey's book had a lot about how it depends very much on the composition of what you spend for. We are hearing that here as some measure of the discussion.

This administration seems to me to be strong believers—although they would never admit it—in what Dick Cheney told Paul O'Neill: “The deficits don't matter.”

I once explained to Dick Cheney that he left out the rest of the sentence, which was “...as long as the Chinese buy the bonds.”

That is one problem we have for the future. Are the Chinese going to buy the bonds in the trillions of dollars that we have? That is a

huge uncertainty that hangs over the long-term effect of what's going to happen to the United States.

The other one is, How much of these bonds are going to be bought by the central bank? They, I believe, rely to a considerable extent on the belief that, as long as unemployment is high, inflation can't occur. From 1933 to 1937, with unemployment never less than 14 percent, prices rose by 12 percent. One of the things about the Phillips' curve estimates that people should bear in mind is that two of the very best chairmen the Federal Reserve had—Paul Volcker and Alan Greenspan—never used those estimates and never relied on them. Their minutes are full of comments by Paul Volcker saying, "I think the staff is terrific; I think their forecasts are terrible, and I don't use them."

The long-term problem is one that needs a good deal of attention. We need to know what tax policy the administration is going to have, because that is going to have an enormous effect on whether we are going to continue consumption at a faster pace or investment at a slower pace, which seems likely.

The current U.S. fiscal policy problem seems to me to be one of asking and answering, How are we going to service the enormous debt that we built up in the past and are going to increase—how are we going to service that debt?

It seems to me the answer has to be that we need to export more. That's obvious. In order to export more, we need to invest more. We have a fiscal policy, which is aimed primarily at encouraging consumption, which is what the United States does not need more of. It needs more investment, so it's going to be in a position to service the enormous debt it has already incurred and the even larger debt that it is going to incur on the projections that the administration itself puts out.

Mr. Dugger: Threading through the comments that have already been made and ending particularly with Allan's, the 900-pound gorilla is in the room. The 900-pound gorilla is a statement that the U.S. borrowing levels, relative to global savings, are at critical levels.

And the United States is not the only country that is borrowing. All the industrialized countries are borrowing. There is pressure on all the central banks to buy—“monetize”—government-guaranteed debt in one form or another.

David Romer’s comment earlier—that it is absolutely imperative that this community think through what it means if the expectational burden of this fiscal circumstance suppresses economic activity in the way that Glenn Hubbard described—is enormously important for this community to think through. If there is not some way to put Goodhart’s genie back in the bottle—if we cannot find a way to put that genie back in the bottle—we need to have concrete plans on what we do if things don’t work out well.

A key aspect of the question on my mind is the one asked yesterday: What was it that we missed that caused us to be surprised by the downturn? What is it now that we may not be thinking about that we should be thinking about? Allan’s and others’ comments point in the right direction. As a community, we need to focus on such questions, to prevent being surprised and to get out of this over the next five to seven years.

Mr. Poterba: On the subject of multipliers, it is important to remember that other economic conditions at the time when these fiscal policy steps are taken are very important for determining what these multipliers might be. The search for a single number for some of these policies may simply be a holy grail. We’ll never get there.

Take the very simple example of what the marginal propensity to consume out of a tax rebate might be. We’ve already heard that it is important to think about what other tax parameters are being changed. Is it rates? Is it the credits? Is it the deductions that are changing? But it is also important in this group, in particular, to remember that things like credit market conditions will be very important. At a time when one changes the level of withholding or changes tax payments, if consumers are locked out of even the credit card market or are facing very tight difficulties in using mortgage debt or other things to refinance some of their other liabilities, the effects of

those policies on spending may be very different than at a time when the credit markets are more available to the consumer.

The same thing is true at the state and local level. At a time when the muni market is virtually closed to state and local borrowers, as it was at one point last fall, the impact of intergovernmental grants may be very different than in “more normal times” in that market. Those other factors are very important to keep in mind as we try to evaluate what some of these spending multipliers might be.

Ms. MacGuineas: Going into the stimulus, one of the heated discussions was whether you should add a fourth “T”—sort of the transformational to the normal Summers’ three T’s. The transformational being whether the government should have more investment, which would lead perhaps to longer-term economic growth, which might compensate for the lack of U.S. consumers being the engines of growth going forward. Putting aside whether you think that was a good idea or not, my question is, When you look back at the stimulus, will we have to analyze it and its effectiveness in a different way as well—sort of the longer-term growth that resulted from that?

Then also, on this whole issue of the fiscal exit strategy, the part in your paper that touches on the fiscal policies and how that works with the budget situation is so important. I would argue that the best thing we could do right now is to announce a credible medium-term consolidation plan. That would help put us on the path to fiscal sustainability, help reassure markets, and it would dovetail with monetary policy. But I also think Glenn Hubbard’s points are very important: that it really matters what is in that policy, putting aside the fact that I cannot picture a scenario where the government could come up with a credible plan right now they could agree upon. Do you think that would be something useful to be announced now and phased in in the future when the economy is strong enough?

Mr. Feldstein: It is important to distinguish the three components of the recent fiscal package, which correspond to the parts of the paper by Alan and Bill. One of the surprising—and hard to believe—numbers is that as a general rule we should think the change in government spending of a dollar will lead to less than a dollar

of increased GDP—a multiplier of less than one. The issue has already been raised by others, and included by Alan, about whether that would be true in the relevant circumstances that we face today. Christy Romer’s estimate of something like one-and-a-half would be much more plausible at a time when we have very large excess capacity and an interest rate of zero.

But we also need to dig down into the different components of government spending to see where the multiplier would be low and where it might be high.

A second point about the relative efficacy of temporary tax cuts and transfers: The evidence supports the theory that we know that those kinds of temporary tax cuts and transfers will have little impact on increasing spending. John Taylor and I looked at the evidence after the 2008 tax cut. We saw that disposable income rose, but there was virtually no impact on personal consumer expenditures. And, if we look at the recent payouts in the current bill for 2009, in May of this year disposable income rose primarily because of transfers and also to some extent because of reduction in taxes by \$180 billion. But consumer spending rose by only \$25 billion, or 15 percent. So, there were no incentive effects in those. In contrast, when the administration brought in the Cash for Clunkers, we saw that every dollar of outlay by the government led to a significant multiple.

Finally, I go back to the point Larry Lindsey made. We just don’t have recent evidence about the impact of transfers to state governments. This is an opportunity, unfortunately, to study that again, because I fear that a lot of the money that is being transferred to state governments will not be spent. They will simply draw down less on their rainy day accounts.

Ms. Romer: I have two points. First, on the multipliers: Marty described the multipliers in the Bernstein and Romer paper as ours. They are, in fact, done by other people, many of whom are in this room. They come from the Fed’s model and from many private forecasters. More fundamentally, the multipliers come from historical experience. And, one of the things that is very important to realize is

that basically any multiplier estimated from history is likely to suffer from downward bias because of omitted variables.

Let me just give you a classic example. If you think about estimating the government spending multiplier from the Korean War experience, it's a big mistake to overlook the fact that we fought that war largely out of current revenues. We raised taxes dramatically. The fact that GDP nevertheless surged is a very powerful sign that in fact the multipliers may be quite large. Here I can't help but cite work that David Romer and I have done that finds that when you try to account for the omitted variable bias, you get substantially bigger multipliers than when you don't.

An important implication of this is that we stand on the edge of learning a tremendous amount about the effects of fiscal policy. One source of new information will be cross-country evidence, because we've had quite different fiscal responses across countries. Some preliminary work we've done at the Council of Economic Advisers suggests that we are seeing differential responses—countries that did bigger fiscal expansions do seem to be recovering faster. That is something we'll obviously be watching, because that is going to be an important piece of information.

I also think if you look at what the private forecasters are saying about the dramatic change that we've seen in GDP growth from -6 percent to -1 percent, somewhere between two and three percentage points of that change is coming from fiscal stimulus.

The second point I have to say is to Allan Meltzer: Deficits do matter. Long-run fiscal solvency is incredibly important. No one believes that more than the president or his economic team. At the same time, I doubt there is anyone in this room who would support a massive fiscal tightening in the current situation. We are approaching 10 percent unemployment, and everyone would agree that nothing would be worse than to make that go even higher.

So, what we need is not actions that will lower the deficit now, but to have an exit strategy. And here I can't help but say one more thing, which I learned from Auerbach and Gale, which is that healthcare expenditures are what are going to kill us if we don't do something.

Nothing could be more important than doing healthcare care reform correctly. Something the administration believes in deeply is the importance of truly slowing the growth rate of costs, because that is something that doesn't contract the economy now but is the critical step in doing exactly as so many have mentioned—putting us on a more sustainable path.

Mr. Gale: Since we started this conference on Thursday night, the administration announced that its 10-year budget deficit estimate went up by \$2 trillion. These are real, live issues. And the same day the administration announced that, presumably as a coincidence, Japan announced that its new strategy for getting people to buy bonds was to stick pamphlets in the backseat of taxicabs. So, we may be seeing some unconventional fiscal policies in the future.

Let me just start by saying I do agree with Allan on the second stimulus issue, in case anyone was worried about that. I am not going to try to address each specific comment. I am going to try to organize my comments around four themes. One is the long-term issue. Two is what I'll call the David Romer question, which is the exit strategy or medium-term issue. Third is the effect of the stimulus package. And fourth is thinking creatively about stimulus.

Long term: It is a rare experience when Alan and I get lectured repeatedly about not paying much attention to the long-term fiscal outlook. Obviously, we think it's crucially important. Getting from here to there is the central fiscal challenge that the country faces. Having a credible way to do that would almost be a luxury. Just doing it would be enough. That is the framework that covers all of this discussion. We accept all the points on the importance of the long-term fiscal framework.

What is more interesting in this particular discussion is the medium-term discussion, what David Romer raised in the context of monetary policy. Policymakers face a very difficult balancing act. If you cut off stimulus too soon, you risk taking the economy back down with you. As Christy just mentioned, this is basically what happened in the 1930s. Likewise, Japan was not fiscally consistent during the 1990s.

If you stop stimulating too soon, you risk bringing down the economy with you. If you stop stimulating too late, you risk creating investor fears and panic and the hard landing. What we talked about a few years ago was the hard landing. Greg Mankiw and Larry Ball presented a paper here in 1995 arguing that conditions then made us susceptible to a hard landing. Robert Rubin, Allen Sinai and Peter Orszag presented a paper in 2004 at the American Economic Association meetings arguing that conditions at that time made us susceptible to a hard landing. It goes without saying that current conditions are much worse and the possibility of a hard landing is presumably much higher.

That is an extremely difficult balancing act. It is important to emphasize that there is no great big econometric literature on how to deal with that. So, policymakers are flying blind a little bit. That seems to be the central issue of the next few years.

If I can turn to a comment that may not be evident to people who are not public finance people: It is going to be very hard to raise taxes or cut spending over the next five years. You can't raise taxes because the Republicans have said, "No new taxes," and the Democrats have said, "No new taxes for 95 percent of all households." And you can't cut spending because three-quarters of spending is Social Security, Medicare/Medicaid, defense, and net interest. Military spending is not going down much. Net interest, if anything, is going to go up, as interest rates recover. Social Security, Medicare, and Medicaid—when we talk about cutting those things, we talk about long-term cuts. On Social Security, no one is talking about reducing current retiree payments; we are talking about grandfathering in everyone who is 55 and older. The only way to cut spending substantially in the next five years is that last one-fourth of the budget, and obviously you'd need very big cuts in that last one-fourth of the budget to have a sizable impact on spending.

Let me summarize this issue, though, with a point I think gets lost. Tom Gallagher told me there was a recent Gallup poll that said people thought the budget was more important than the economy. People would rather have a lower deficit and a less-well-performing economy than a better-performing economy and a higher deficit.

But the economy is more important than the budget. We need to keep that in mind, and we need to tell policymakers that, and policymakers need to know that.

Third point: the effect of the stimulus package. One of our constant themes was that you can't figure out from the historical multipliers what the effect of the stimulus package is because, with apologies to Ken Rogoff, this time it is different. Let me highlight a couple of things that might matter here.

One is the expectations issue. Monetary policy and fiscal policy were both set up so they would respond massively. The Fed made it very abundantly evident they were not going to stand by; they were not going to let the economy go down. The Obama administration said the same thing. That could conceivably create a set of expectations that has a more powerful effect than the actual tax-and-spending policies themselves. The stimulus could have had a much bigger effect in this first six months than you would suspect just from seeing the aggregate federal spending.

Marty and Larry mentioned the issue with state and local transfers. This is a really interesting issue to think about, and they are right. There is no literature on this. The idea is that states have balanced-budget rules so that in a recession when the revenues go down, they have to cut their spending. That is exactly the wrong thing to do from the context of macroeconomic stabilization. If the federal government gives them a dollar, then they will not cut spending by that same dollar. That is the logic. We don't know whether that holds or not. Marty and Larry both mentioned reasons to wonder about that. The one piece of evidence that may be relevant is that state and local employment went up in the second quarter of the year, which might give us a little information on that. But that is definitely an issue we need to know more about. The financing strategy, the debt situation, all of that we need to know more about, too.

Let me highlight one other thing. Glenn mentioned Hall's estimate that the multiplier for government spending is 0.75. That is for spending on military items. There is an interesting issue in the composition of government purchases. Most of it is nonmilitary, but most

of the shocks have been military shocks. The literature that estimates this—Valerie Ramey and some of the others—focuses extensively on military shocks. But the theory of how health and education spending would affect the economy isn't the same as how a military shock would affect the economy. We know even less about the aggregate impacts of nonmilitary spending than of military spending. But, of course, everything in the stimulus package was nonmilitary.

Last point: There has been a revolution in economics regarding the integration of psychology in economics—behavioral economics. It has been particularly pronounced in areas relating to saving: how to get people to save more, how to create contests, how to make it fun, how to think about more than just shifting the budget constraint. Saving, of course, is just the flip side of consumption. There is some evidence that we highlight in the paper that you can do the same thing on the consumption side. The 1992 withholding changes did not alter people's after-tax income. They just altered the composition of it during the year. There is some evidence from surveys that people actually spent some of that increased funding.

The Cash for Clunkers, an issue that Marty mentioned, is another example of this. It is sort of like the good side of a bank run. In a bank run, everybody goes immediately because you need to arrive faster than the other guy does. Well, in this new initiative, the government specified a certain amount of money, and you could get it if you arrived there first. That created a contest and a buzz, and it was enormously popular. Whereas typically our models would say that as a targeted in-kind incentive, it would be less likely to be taken up than a cash incentive, where the funds are fungible, etc.

There is some scope for thinking about creative, unorthodox ways that we could stimulate consumption or stimulate investment. I'll just leave you with that thought.

