

**Perspectives on the U.S. Economy: Fiscal Policy Issues**  
Testimony before the Committee on the Budget  
U.S. House of Representatives

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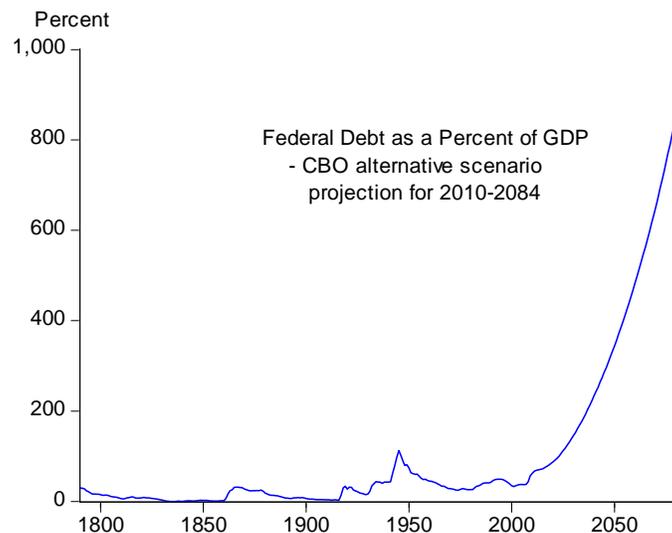
July 1, 2010

Thank you, Chairman Spratt, Ranking Member Ryan, and other members of the House Committee on the Budget for inviting me to testify on “Perspectives on the U.S. Economy.”

The recovery of the U.S. economy has slowed significantly since the start of this year. After rebounding to 5.6 percent in the fourth quarter of last year, real GDP growth slipped to 2.7 percent in the first quarter and is expected to remain in the 3 percent range for the rest of the year. In the lingo of economics it is a U-shaped recovery rather than a V-shaped recovery and some economists are now predicting a double dip, or a W-shaped recovery. As a result of the slower economic growth unemployment remains high and is expected to decline slowly.

***Uncertainty and Fiscal Policy Inconsistencies***

In my view the weakness in the recovery is mainly due to uncertainty about economic policy and concerns about how large policy inconsistencies will be resolved in the future. The long term budget outlook released yesterday by the Congressional Budget Office (CBO) is a timely reminder of these inconsistencies as this alarming chart of past and future federal debt illustrates.



The chart shows the federal debt as a share of GDP going back to the beginning of the United States and continuing into the future assuming that fiscal policy is not changed as defined by the CBO's alternative scenario. You can see the increase in the debt ratio during World War II, which fortunately was reversed in the years after the war. The CBO's projection through the next decade shows a similar increase in federal debt as a share of GDP as in World War II. The projections for future decades then explode. According to the CBO, the debt reaches an unbelievable 947 percent of GDP by 2084 which dwarfs the peak debt incurred during World War II. So something has to give, and people are beginning to wonder what.

The near term increase in the debt is due to the recession, the stimulus packages, and other recent expansions in government spending growth. The longer term increase is due to the inability to rein in spending on entitlement programs. Thus it is not only the fiscal response to the crisis that has caused debt problems for the United States. But the response to the crisis has distracted us from efforts to address the problems. Adding to the uncertainty is that many tax provisions are scheduled to expire in just 6 months, and without legislative action, there will be substantial tax increases on all Americans. There is also a looming change in financial market regulations which add uncertainty to a financial system still recovering from the crisis.

A clear and credible path of fiscal consolidation is clearly needed and would do much to remove uncertainty about future policy and thereby build confidence. The reason why such a plan is not being articulated and carried out now is an apparent concern that such a consolidation would remove needed stimulus from the economy. In my view, the fiscal stimulus packages did not stimulate very much if at all and ending them would not have such negative consequences. But the debate is a serious one and for this reason I want to devote the rest of my testimony to explaining why I disagree with those that claim the stimulus has worked.

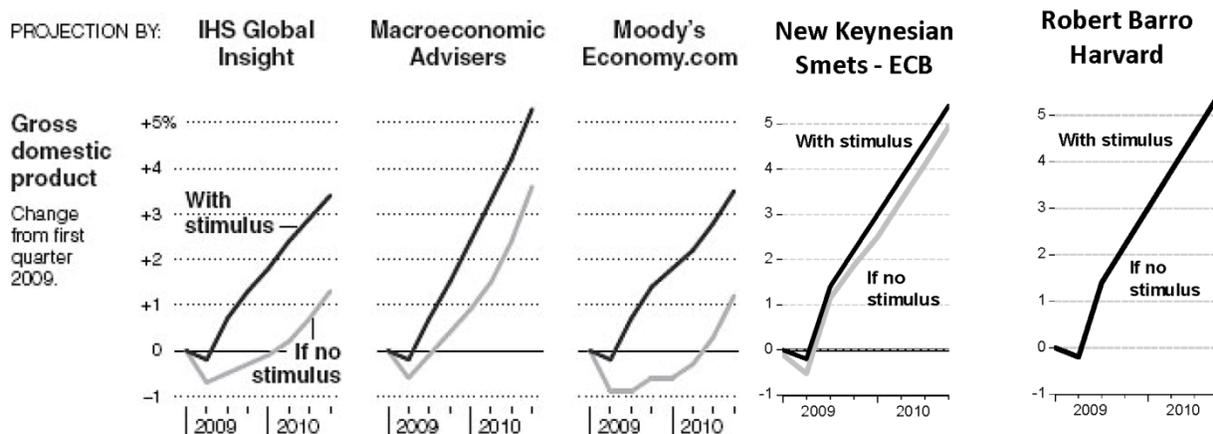
### ***Evidence from the Models: No Consensus that the Stimulus Had a Significant Impact***

Unfortunately most attempts to answer the question "What was the impact of the fiscal stimulus?" are still based on economic models in which the answer is built-in, and was built-in well before the stimulus package was enacted. Frequently the same economic models that said, a year and half ago, that the impact would be large are now used to show that the impact is in fact large. In other words these assessments are not based on the actual experience with the stimulus. I think this has confused public discourse.

An example is an article in the *New York Times* (11/21/2009) with the headline "New Consensus Sees Stimulus Package as a Worthy Step," which states that "accumulation of hard data and real-life experience has allowed more dispassionate analysts to reach a consensus that the stimulus package, messy as it is, is working. The legislation, a variety of economists say, is helping an economy in free fall a year ago to grow again and shed fewer jobs than it otherwise would."

As evidence the article includes simulation results from three models, which are reproduced in the three charts on the left below. Each of the three graphs on the left corresponds to a model maintained by the group shown above the graph. All three graphs show that without

the stimulus the recovery would be considerably weaker. The difference between the black line and the gray line is their estimated impact of the stimulus. But this difference was built-in to these models before the stimulus, and in this sense there are no new hard data or experiences here.



In fact other economic models predicted that the stimulus would not be very effective, and, using the same approach those now say that it has not been very effective. To illustrate this I show two other graphs on the right-hand side of the chart which did not appear in the *New York Times* article. The first one is based a model estimated by Frank Smets, Director of Research at the European Central Bank, and his colleague Raf Wouters. The difference between the black and the gray lines is what is predicted by that model. Note that the impact is very small. The second additional graph on the right is based on the research of Professor Robert Barro of Harvard University who reported in an article in the *Wall Street Journal* “when I attempted to estimate directly the multiplier associated with peacetime government purchases, I got a number insignificantly different from zero.” So according to that research, the difference between the black and the gray line should be about zero, which is what that graph shows. So there is no consensus among models or theories that the stimulus had a significant impact.

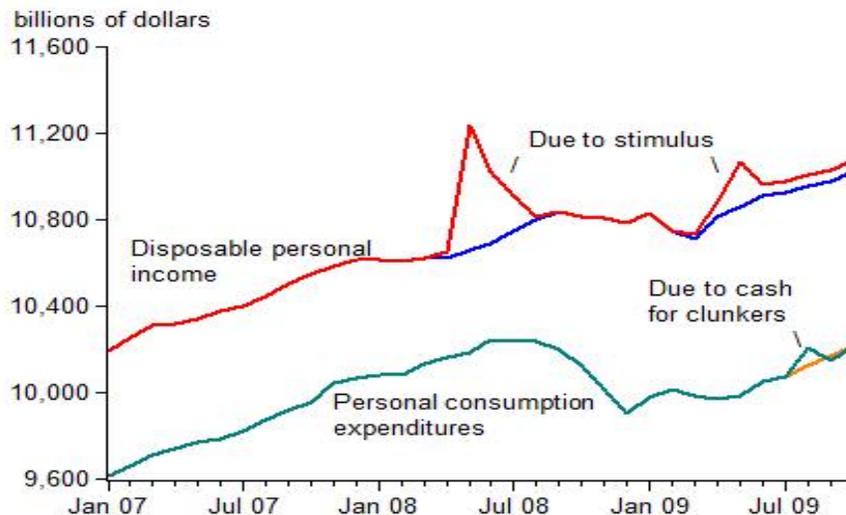
Other evidence from models comes from an International Monetary Fund study which reports estimates of government spending impacts which are much smaller than those previously reported by the Administration. The IMF uses a very large complex model called the Global Integrated Monetary and Fiscal (GIMF) Model. It shows that a one percent increase in government purchases (as a share of GDP) increases GDP by a maximum of 0.7 percent and then fades out rapidly. This means that government spending crowds out other components of GDP (investment, consumption, net exports) immediately and by a large amount. The IMF estimate is much less than the impact reported in a paper released last year by Christina Romer of the Council of Economic Advisers and Jared Bernstein of the Vice President’s Office.

John Cogan, Volker Wieland, Tobias Cwik and I raised questions about the Romer-Bernstein estimates soon after they were released in January 2009 because the estimates seemed to be

much different from comparable estimates based on more modern models. In fact, we found the economic impacts to be much smaller. Since then many technical papers have been written on this subject and in my view the consensus is that the impacts are much smaller than originally reported by Romer and Bernstein.

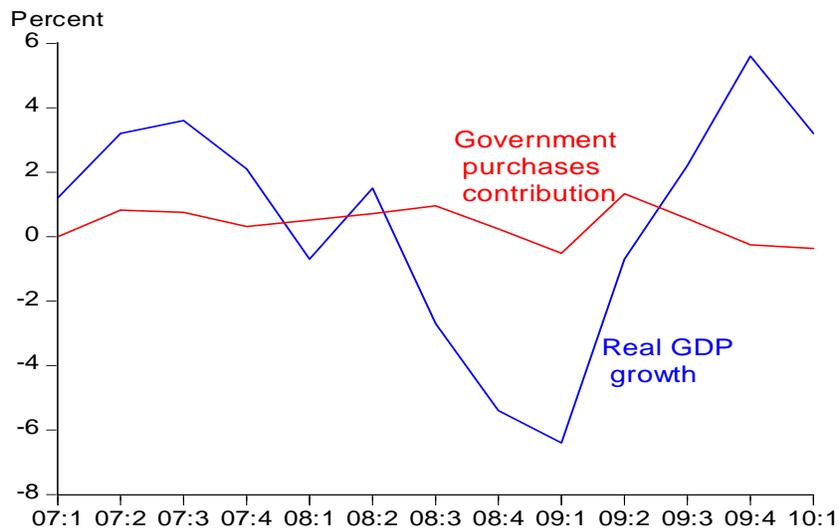
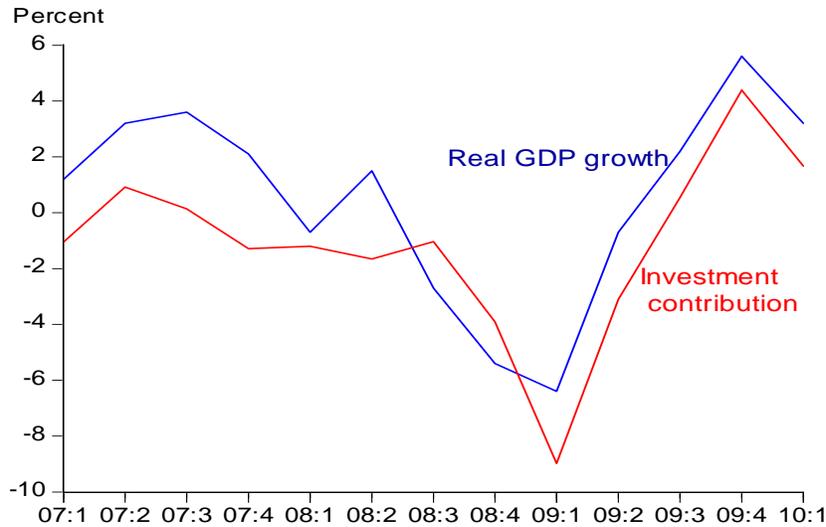
### ***Evidence from the Facts: The Stimulus Did Not Have a Significant Impact***

Now let me go beyond the models and look at the direct impacts using data. Consider first the 2008 discretionary countercyclical fiscal stimulus—the Economic Stimulus Act of 2008—in which checks were sent to people on a one-time basis and aggregate disposable personal income jumped dramatically though temporarily. The objective of the stimulus was to jump-start consumption demand and thereby jump-start the economy. However, aggregate personal consumption expenditures did not increase by much at all around the time of the stimulus payments. For the discretionary fiscal stimulus which was passed in February 2009—the American Recovery and Reinvestment Act of 2009—checks were also sent; they were smaller and more drawn out than the 2008 stimulus, but the impact was about the same: no noticeable effect on consumption. Both cases are illustrated in the chart below. This is what basic economics—in particular the permanent income theory and the life cycle theory of consumption—would predict from such temporary lump-sum payments.



In addition, my analysis of the government spending part of the stimulus suggests that it had little to do with the turnaround in economic activity. Indeed the swings in economic growth from positive to negative during the recession and again to positive during the recovery (including the slowdown to 2.7 percent growth rate of real GDP in the first quarter) provides evidence that changes in government spending had at best a very small contribution to the recovery. Most of the recovery has been due to investment—including inventory investment,

which was positive in the first quarter after declining for all of last year—and has little to do with discretionary stimulus packages. The two charts show the percentage contribution of investment and government purchases to real GDP



The charts clearly indicate that the changes in real GDP growth have been mostly due to changes in investment and little to changes in government purchases. In fact, government purchases were a drag (a negative contribution to real GDP growth) in the fourth quarter of 2009 and the first quarter of 2010.

One could argue that government spending might have declined by a larger amount without the stimulus because the stimulus package prevented state and local government from cutting spending. More research is needed to determine what would have happened in the counterfactual

of “no discretionary stimulus,” but in the meantime these data at the least suggest that the recovery and the slowdown have been due to changes in investment not government purchases.

### ***Conclusion***

The combination of the unsustainable debt projections illustrated in my first chart and the little if any impact of the stimulus packages illustrated in my other charts has clear policy implications: Fiscal policy should avoid further debt-increasing stimulus packages which do little to stimulate employment or GDP. Fiscal policy should focus on reducing the deficit and the growth of the debt-to-GDP ratio. Reforming existing entitlement programs to hold their growth down and limiting the creation of additional entitlement programs are essential.