The State of the Economy and Principles for Fiscal Stimulus

Testimony before the Committee on the Budget
United States Senate

John B. Taylor
Professor of Economics, Stanford University
Senior Fellow, Hoover Institution

November 19, 2008

Thank you, Chairman Conrad, Ranking Member Gregg, and other members of the Senate Budget Committee for giving me the opportunity to testify about the state of the economy and options for a second fiscal stimulus.

The State of the Economy and the Financial Markets

The most recent data for September and October confirm that the current recession will be longer and deeper than the previous two recessions in 1990-91 and 2001 and more like those in the 1970s and early 1980s. Retail sales, personal consumption expenditures, employment, industrial production, consumer confidence all fell sharply in October confirming forecasts that real GDP will decline by 3 percent or more in the current quarter after falling 0.3 percent last quarter.

The current downturn is directly connected to the credit crunch. A good measure of the severity and length of this credit crunch is the spread between three month interbank lending rates and the overnight rate over the same period, shown in Figure 1.

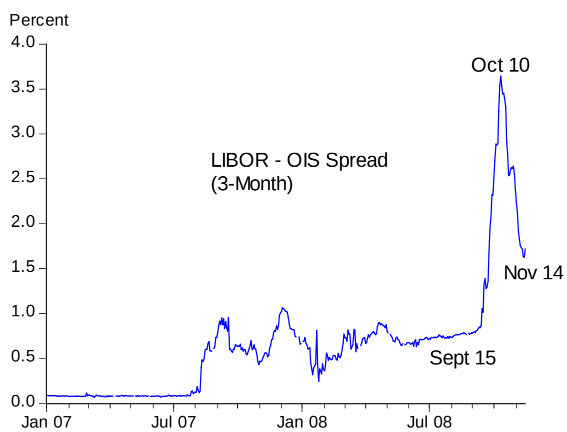

Figure 1. The key measure of tension in the financial markets—the spread between interest rates on three month interbank loans (LIBOR) and expectations of rates on overnight interbank loans (OIS)—has declined, but remains very high.

This spread increased sharply in August of last year and remained elevated for a full year during the financial crisis before rising even more sharply in late September and early October of this year when the financial crisis became acute. The spread has come down recently, but still remains above the elevated level seen during the first year of the crisis. Until the spreads return to more normal levels credit markets will continue to be a drag on the economy.

The financial crisis evidenced in Figure 1 can be traced to unusually low interest rates in the early part of this decade which let to the housing boom and bust, and then to massive delinquencies and foreclosures on home mortgages, increased riskiness and declining prices on securities derived from these mortgages, and a resulting deterioration of the balance sheets of banks and other financial institutions around the world that held these securities. With the need to deleverage, banks have become much more reluctant to make new loans, and this has caused economic growth to slow. The housing bust and sharply rising energy prices earlier this year have also been significant drags on the economy. Recently the downturn in the United States and several other economies suffering from credit crunches has negatively affected economic growth in emerging market economies around the world.

Because of the unprecedented nature of the financial crisis, it is difficult to estimate how long it will last. There are some similarities with the credit crunch in 1980 when government controls on credit caused economic growth to decline sharply. As soon as those controls were removed the economy bounced back, but economic growth still remained subpar through 1981 and 1982. If the severity of this credit crunch is reduced, economic growth will likely bounce back from very low levels, but is likely to remain slow into next year. The economy will likely operate below its potential for several years.

Principles for a Second Stimulus

Given the tough economic times and an uncertain outlook it is not surprising that many are considering another fiscal stimulus to follow the Economic Stimulus Act of 2008. In my view there is much that can be learned about options for a second stimulus by looking at the impact of the first stimulus thus far.

The Impact of the First Stimulus

A major part of that stimulus was the temporary payment of funds to individuals and families. These payments were made mainly in May, June, and July of this year, so it is possible to assess their impacts. The other part of the Economic Stimulus Act was the bonus depreciation and enhanced expensing, which apply through the end of this year, and are thus too early to evaluate.

The theory behind the temporary rebate payments is that they would increase the demand for consumption, stimulate aggregate demand, and thereby get the economy growing again. What were the results? Did they work as the theory predicted? Figure 2 tells the story in a very straightforward way.

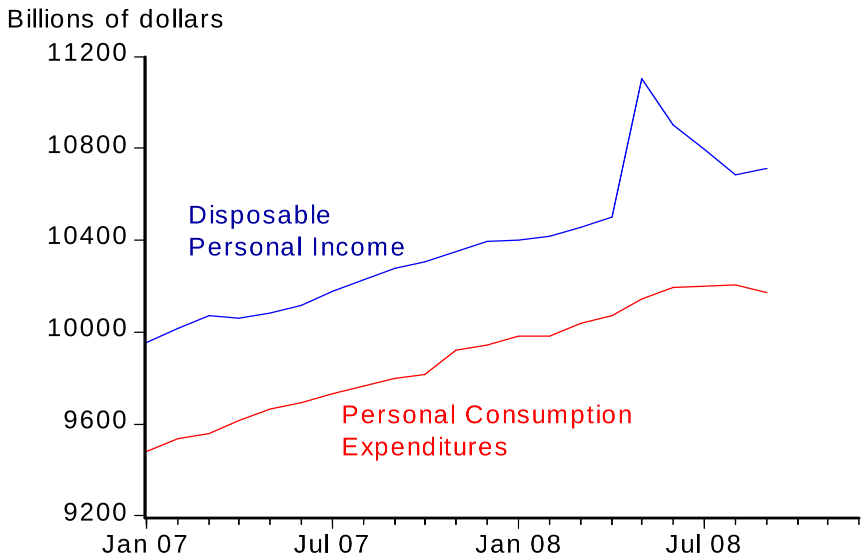

Figure 2. Income and consumption before, during, and after the May-July economic stimulus program

There are two lines in Figure 2. First consider the upper line, which shows disposable personal income in the United States for the months from January through September of this year. (September is the latest month available from the Bureau of Economic Analysis. The data are seasonally adjusted and are stated at annual rates.). Disposable personal income is the total amount of income that households have left over after taxes are taken out and transfers from the government are added in. Notice the sharp increase in disposable personal income in May when rebate checks were mailed out or deposits were made directly into people's bank accounts. The level then remained relatively high in June and July as payments continued, but by August had returned to the trend that was prevailing in April before the payments started being made. In sum, the big blip in the upper line in Figure 1 is due to the rebate payments.

Next consider the lower line which shows personal consumption expenditures by households in the United States. Observe that consumption shows no noticeable increase at the time of the rebate. Hence, by this simple aggregate measure, the temporary rebate did little or nothing to stimulate consumption demand, aggregate demand, or the economy.

Given the strong support for the Economic Stimulus Act of 2008, these results may seem surprising. No doubt some will question them, saying, for example, that other forces would have driven consumption down were it not for the rebates. But the results are not at all surprising in my view. They correspond very closely to what basic economic theory tells us. According to the permanent income theory of Milton

Friedman, or the life cycle theory of Franco Modigliani, temporary increases income will lead to at best small increases in consumption, which appears to be what happened according to the aggregate data in Figure 2. If the increases in income were permanent, as in the case of a permanent tax cut, then the increases in consumption would be expected to be much larger.

To be sure, the permanent income theory is not perfect and economists have shown that consumers who find it difficult to borrow may spend more than predicted by the theory. But even then the increase in income will only add temporarily to consumption, and will not be the kind of policy that would get a large dynamic economy like the United States moving again. In other words short impulses, such as one to three months of rebates, will not jump start an economy which has been pulled down for over a year by a housing slump, a financial crisis, and high energy prices, and where expectations of future income and employment growth are low for years into the future. And it is always difficult to determine when such a short impulse would have the best effect. The theory that a short-run stimulus of this kind will jump start the economy is based on older largely static "Keynesian" theories which do not adequately account for the complex dynamics of a modern international economy or expectations of the future now built into decisions in virtually every market.

After years of study and debate, such arguments led many economists to conclude that discretionary fiscal policy actions, such as temporary rebates, are not a good policy tool. Rather fiscal policy should focus on the "automatic stabilizers," which are built into our tax and transfer system, and on longer term more permanent fiscal changes that will positively affect the long-term growth of the economy. Indeed, this was the conclusion of my research, as summarized in Taylor (2000), and that of many others. As Eichenbaum (1997) put it, "there is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible," or, according to Feldstein (2002), "There is now widespread agreement in the economics profession that deliberate 'countercyclical' discretionary policy has not contributed to economic stability and may have actually been destabilizing in the past."

To be sure, that consensus apparently broke down during the debates about the fiscal stimulus early this year when a number of economists testified to the effectiveness of such a temporary stimulus program (see Elmendorf and Furman (2008) and Council of Economic Advisers (2008), for example)). One reason for that change in views by some economists might have been the apparent success of rebate payments made in 2001. However, those were part of, or the first installment of, more permanent multiyear tax cuts passed that same year. Hence, they were not temporary. In my view the recent evidence shows that the consensus going into this decade remains valid, and that policy makers need to be wary of such short term stimulus programs. They are unlikely to help the economy and will increase the deficit and debt as they did this past fiscal year.

The recent evidence also raises questions about various "bang for the buck" estimates that are used to evaluate or to rank stimulus options. For example, according to one estimate, GDP would rise by about a dollar and a quarter for every dollar of a refundable one-time tax rebate (Zandi (2008)). But Figure 2 suggests the bang for the buck was at best only a few pennies. Even if we wait longer and control for other influences on consumption, it is doubtful that the bang for the buck could amount to much based on this experience.

Lessons Learned: Permanent, Pervasive, and Predictable

What are the implications of this evaluation of the first stimulus for a possible second stimulus? The mantra most often heard during the debates about the first stimulus was that it should be *temporary, targeted, and timely*. (See Elmendorf and Furman (2008), for example). Going forward, we clearly need a new set of principles and a new mantra. Based on recent and many past experiences as well as much economic theory, and in keeping of course with the need for alliteration, I recommend an alternative stimulus mantra: *permanent, pervasive, and predictable*.

> ***Permanent***. The most obvious lesson learned from the stimulus program of this year is that one should have strong misgivings about a temporary stimulus program. Such a program is not likely to have much impact, and any impact it has will be short lived. Temporary is not a principle we want to follow if we want to get the economy moving again. Rather we should be looking for more lasting or permanent fiscal changes. For all the reasons stated above, more lasting or permanent tax changes will be more effective in helping to turn the economy around in a lasting way. With negative or low economic growth projected well into the future, the economy needs a long-term fix. We need to worry about the next few years, not just the next few months.
>
> ***Pervasive.*** One of the arguments in favor of "targeting" the first stimulus package was that by focusing on people who were "liquidity constrained" the bang for the buck would be larger. But such targeting did not keep the stimulus from being ineffective. Moreover, targeting implies that letting tax rates increase, as currently on the books, will not be a drag on the economy as long as tax revenues decline in total, or on net. But increasing tax rates on businesses or on investments, especially in the current weak economy, would increase unemployment and further weaken the economy. Better to seek an across the board approach where both employers and employees benefit. When people are losing their jobs and their life savings, the last thing they want government to do is increase tax rates on the firms who hire them or on the asset markets where their money is invested.
>
> ***Predictable.*** While timeliness is an admirable attribute, it is only one temporal property that a good fiscal policy should have in a large dynamic economy. Even more important is that policy actions be clear and understandable—that is predictable—so that individuals and firms know what to expect as they make decisions which depend on future government actions. One of the most widely-heard complaints about government interventions in the current crisis is that they have been too erratic or even ad hoc. In my view financial markets are clamoring for clarity. Indeed, that we are here today discussing the need for a second

stimulus so soon after the first stimulus is an example of a lack of predictability in policy. Economic policy—from monetary policy, to regulatory policy, to international policy, to fiscal policy—works best if it is as predictable as possible.

I believe that there are many good fiscal packages that are consistent with these three principles. One would consist of the following: (1) A commitment, passed into law, to keep income tax rates were they are now, effectively making current income tax rates permanent. This would be a significant stimulus to the economy and to the financial markets because tax rate increases are now expected on a majority of small business income, capital gains income, and dividend income. Committing to keep marginal tax rates from increasing will boost the economy right now. This commitment on tax rates could be reinforced with a pledge not to alter current international trade agreements, which would give additional stimulus to the economy. (2) Enactment of a worker's tax credit, perhaps equal to 6.2 percent of wages up to $8000 as President-elect Obama has proposed, but permanent rather than a one-time check of up to $500 per worker. (3) Responsible government spending plans that meet reasonable long-term objectives, put the U.S. economy on a credible path to budget balance, and are expedited to the degree possible without causing waste and inefficiency. (4) An explicit recognition that the "automatic stabilizers" are likely to be as large as 2.5 percent of GDP this fiscal year, will help stabilize the economy, and should be viewed as part of the overall fiscal package even though they do not require legislation.

References

Congressional Budget Office (2008), "Options for Responding to Short-Term Economic Weakness," January 2008

Council of Economic Advisers (2008), "The Case for Fiscal Policy to Forestall Economic Slowdown," Executive Office of the President, January 18.

Eichenbaum, Martin (1997), "Some Thoughts on Practical Stabilization Policy," *The American Economic Review*, Vol. 87, No. 2, (May) pp. 236-23

Elmendorf, Douglas W. and Jason Furman (2008), "If, When, How: A Primer on Fiscal Stimulus," Brookings Institution, January 10

Feldstein, Martin (2002), "The Role for Discretionary Fiscal Policy in a Low Interest Rate Environment," NBER Working Paper

Taylor, John B. (2000) "Reassessing Discretionary Fiscal Policy," *The Journal of Economic Perspectives*, Vol. 14, No. 3., pp. 21-36.

Zandi, Mark (2008), Written Testimony before the House Committee on Small Business Hearing on "Economic Stimulus for Small Business: A Look Back and Assessing Need for Additional Relief," July 24.