On Designing a Fiscal Stimulus--Quickly

Testimony of
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Mr. Chairman, members of the Committee, I'd like to thank you for the opportunity to testify here today on the fiscal stimulus issue. This is not only an important question for the Budget Committee, but one that the Senate needs to deal with almost immediately.

I'd like to organize my testimony around five questions:

1. As a generic matter, when and why should Congress think about enacting fiscal stimulus?
2. Do these conditions apply today?
3. Should a fiscal stimulus package be paid for?
4. As a generic matter, how should a stimulus package be designed?
5. How should those general guidelines be modified to tailor the package to current circumstances?

1. When and why should there be fiscal stimulus?

For the most part, we rely on the Federal Reserve to regulate the macroeconomy, cutting interest rates when the economy looks weak and raising them when the economy strengthens. As a general matter, the Fed has performed this function admirably over the past 25 to 30 years. So when and why should Congress seek a role in this job?

First, under normal circumstances, *it shouldn't*. It is important to preserve the independence of the Fed so that it can do its job in an apolitical, technocratic way.

But there are circumstances in which the Fed either cannot or should not go it alone. I'll spare you an exhaustive list and focus on the one that presumably applies today:[1] namely, when the economy deteriorates rapidly and unexpectedly, the Fed's medicine—interest rate cuts—may be too slow-acting to cure the patient. Let's be clear about this. The Fed can take action on a moment's notice, as it did just eight days ago. (The FOMC is expected to cut rates again in a few hours.) But six months to a year elapses before interest rate changes have any substantial effects on economic activity. If the economy starts sliding downhill fast, that may be too long to wait.

This simple observation already suggests the first crucial design principle for fiscal stimulus:

Fiscal stimulus must be fast-acting, or else it loses its basic rationale.

It is important to realize that the term "fast-acting" encompasses three distinct aspects, and they all matter. First come the *political lags*. For a stimulus to be effective, Congress must enact it quickly—in the current context, I would say we need a bill by the end of this quarter. Fortunately, Congress seems to be acting with amazing speed on this matter. In terms of program design, political lags suggest concentrating on items for which a bipartisan consensus exists or can be cobbled together quickly.

Next come *implementation lags*. For stimulus to be timely, there must be minimal administrative barriers and delays involved in implementing whatever policies are enacted. That probably precludes, for example, starting new government programs from scratch.

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[1] For more detail, including other possibilities, see Alan S. Blinder, "The Case Against the Case Against Discretionary Fiscal Policy," in R. Kopcke, G. Tootell, and R. Triest (eds.), *The Macroeconomics of Fiscal Policy* (MIT Press: 2006), pp. 25-61.

Last, but not least, come *expenditure lags*. For stimulus to be effective, the policies, once promulgated, must induce more spending promptly. I'll have more to say about the implementation and expenditure lags when I talk about specifics of program design later.

2. Do we need a fiscal stimulus now?

Years ago, I kept a corny card pinned to my bulletin board. It read: "My final decision is maybe." I am feeling a bit that way about stimulus right now, though I'd change the "maybe" to "probably." Let me explain why.

Under the consensus forecast, the U.S. economy is in for two, maybe three, rocky quarters: especially the fourth quarter of 2007 and the first quarter of 2008. Then things will start to improve. Furthermore, the first of these rocky quarters is behind us, and we are already living in the second. So if the consensus forecast comes true, there is little reason for fiscal stimulus. Similarly, the latest CBO forecast, issued just a week ago, predicts an average real GDP growth rate of 1.5% from the fourth quarter of 2007 to the fourth quarter of 2008, and an average unemployment rate in 2008 that is more or less where it is now.[2] These are not forecasts of recession.

But there are a few problems. First, forecasts are not that accurate. Second, the consensus forecast itself is being marked down. Indeed, the main reason why the new CBO forecast is below consensus is that it is so recent. Third, these markdowns are probably not over; the recent news has been bad. Fourth, a number of observers believe we are in for much worse than the CBO foresees: a recession or even a severe recession (which we have not experienced since the early 1980s). I myself would put the

[2] See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008, page 22.

probability of recession around 50%. If the economy performs much worse than the current CBO forecast, fiscal stimulus will certainly look wise in retrospect.

So how does Congress, lacking a crystal ball, decide what to do *now*? Consistent with my corny motto, my preference right now is to watch and wait, though not for long, and then to act with great dispatch if the need becomes clear. The wait I am talking about is very short. I would like to see one more employment report (which is coming out in two days) and one more report on retail sales (which is coming out in two weeks). If the January numbers are as bad as the December numbers, I'd recommend fiscal stimulus immediately. But if incoming data suggest that December was a fluke,[3] we may want to hold our fire for a bit.

To speed up the legislative process, I would recommend a specific "fast track" procedure under which Congress agrees on a stimulus program as soon as possible, writes the legislation, but does not put it into effect just yet. Instead, we let a little more time go by to see if we really need stimulus. At that point, Congress should hold a straight up-or-down vote on whether to put the previously-designed stimulus package into effect. If the data for January look bad, this delay will amount to nothing. But if they come in unexpectedly strong, I'd advise waiting another month or so.

Some economists have suggested a similar but different approach: creating a trigger mechanism that would put the stimulus package into effect when, say, the unemployment rate rises by a certain amount (or for a certain number of months).[4] I've never been a big fan of mechanical triggers; they miss all the nuances. And it doesn't now appear to be

[3] Or if the bad news gets revised away, as sometimes happens.
[4] See, for example, Martin Feldstein, "How to Avert a Recession," *The Wall Street Journal*, December 5, 2007.

needed to speed up the Congressional process. But if it is, I'd sign on to the trigger idea. That is best left to your judgment.

3. Should the stimulus be paid for?

My answer here is a clear *no*. But to explain why, I need to be a bit pedantic--for just one paragraph. So, with due apologies…

Mainstream economists believe that GDP is basically *demand-determined* in the short run but *supply-determined* in the long run. That means, roughly, that if you want to influence where GDP will be two or three *quarters* from now, you can pretty much ignore capital formation, labor force, technology, productivity, and other determinants of aggregate *supply* and simply work on aggregate *demand*—that is, on spending. On the other hand, if you want to influence where GDP will be five *years* from now, you can pretty much ignore aggregate demand and focus instead on the determinants of aggregate supply that I just mentioned.

The point of this pedantry is that fiscal stimulus is inherently a *short-run* policy that must therefore focus on boosting *spending*, not on boosting productivity—even though the latter is what we care about in the long run. So, while there may be many good reasons to favor policies--like deficit reduction, infrastructure building, or permanent changes in the tax code--that can bolster long-term growth, the second good design principle for stimulus is:

Fiscal stimulus should have maximal short-run impacts on spending.

The concerns with excessive budget deficits that are so familiar to this Committee make pay-go an attractive idea, one that I have long supported. But these worries revolve around aggregate supply and long-run growth. You all know the arguments. When the

government borrows too much, it pushes up real interest rates, which impedes capital formation and, hence, future productivity.

But the relevant time frame here is long. To justify a fiscal stimulus, the nation must be facing a short-run emergency. And in such cases, it's best to set aside our long-run concerns about deficits *temporarily,* and concentrate instead on solving the short-run problem. Paying for stimulus by, say, raising taxes or cutting spending elsewhere would rob the stimulus of much of its punch.[5]

That said, our valid long-run concerns about budget deficits do dictate that the stimulus should be short-lived, which is the third design principle:

A fiscal stimulus package should be temporary.

In the current context, I'd say it should last no longer than a year. A little budget arithmetic is useful here. A stimulus package that raises the deficit by, say, $150 billion for just one year will increase the national debt by $150 billion *just once*. And that will, in turn, add perhaps $5 billion or so to the annual debt service bill. That's not much. And if the Committee is absolutely determined not to raise the long-run deficit at all, the necessary offset would be only $5 billion a year.

4. Designing a stimulus package: general guidelines

You may recognize these three principles—fast-acting, targeted to boost spending, and temporary—as the three emphasized in the excellent recent report from The Brookings Institution's Hamilton Project.[6] That's not entirely a coincidence, since I am a member of the project's Advisory Council.

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[5] In principle, one could have a balanced-budget stimulus by, say, cutting taxes that have strong effects on spending while raising taxes that have weak effects on spending. In practice, this is quite difficult.
[6] Douglas Elmendorf and Jason Furman, "If, When, How: A Primer on Fiscal Stimulus," *Hamilton Project Strategy Paper*, January 2008.

To what sorts of concrete policies do these general principles lead? Mainly to reductions in existing taxes (rather than newly-designed tax cuts) on, and to increases in existing transfer payments (rather than new types) to, those people who are most likely to spend the money quickly. Loosely speaking, that means people who live from paycheck to paycheck, if indeed they get a paycheck at all.

That logic leads me to start the list with two programs that the President and the House somehow left out: Unemployment Insurance and Food Stamps. It is hard to think of a group of Americans who are more likely to spend the marginal dollar than families that have been forced by job loss to scale back their normal standards of living. Unemployment benefits have long been stingy in the United States--in coverage, in duration, and in the level of benefits. Each could be enhanced. The duration is easiest to extend on short notice; indeed, that used to happen regularly in recessions.[7] More generous Food Stamps would also have high bang for the buck. It's an extremely well-targeted program whose benefits go largely to families that are—quite literally—living hand to mouth.

After those two, I'd think next about temporary reductions in either income or payroll taxes aimed at low- and middle-income households—which is, of course, the centerpiece of the House proposal. Since many of these people earn too little to owe income tax, I was happy to see that the so-called income tax rebates will be at least partially refundable.[8] We don't want to design a stimulus program that leaves out tens of millions

[7] In the longer term, we should be extending UI benefits to part-time workers.
[8] Another approach, of course, would be to use payroll tax rebates.

of low- and moderate-income households.[9] They are both in greater need and more likely to spend the money than the average income-tax-paying household. To turn Franklin Roosevelt's well-known maxim on his head, in the case of fiscal stimulus, good morals are also good economics.

Finally, on the spending side, one of the most plausible ways to induce a quick spending response is to boost federal payments to hard-pressed state or local governments. (Medicaid is one commonly-suggested vehicle.) These governments typically operate under balanced-budget mandates, and so are forced to follow pro-cyclical fiscal policies when weak economies make their revenues sag. Federal support can help head off tax hikes and/or expenditure cuts designed to balance state and local budgets. That, too, constitutes stimulus.

Notice that I have left business tax cuts off my list. These sorts of measures have their place. But to think that they will provide the kind of quick jolt that we need now is a triumph of hope over experience.

5. Designing a stimulus package for today

I haven't yet said anything about magnitudes, because that depends entirely on the specifics of the case. Here are two quick back-of-the-envelope calculations that lead to a package of roughly the size the President and the House have agreed to.

Suppose the economy grows at a 1% annual rate during the first half of 2008 and a 2% annual rate during the second half, which is roughly the CBO forecast. As I noted earlier, this below-consensus forecast does not embody an outright recession. Still, if trend growth is about 2¾%, we would lose about 1¼% of GDP relative to trend under this

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[9] The Center on Budget and Policy Priorities estimated that fewer than 60% of households would receive full benefit from a rebate that went only to income taxpayers. (See their website, www.cbpp.org, for details.)

scenario. A stimulus of around 1% of GDP then seems about right in that case. A second way to get to the same number is to calculate the reduction in GDP growth that stems directly from the slump in housing (the "residential investment" component of GDP). That, too, has been running strikingly close to 1% of GDP for almost two years now.

Now, there is nothing magical about exactly 1% of GDP, which is roughly $140 billion these days. Think of it as a reasonable benchmark instead. $140 billion sounds like a lot of money—it's almost as large as the entire FY2007 deficit. But this is a very big economy we're trying to turn around. Furthermore, the $140 billion would be spread over two fiscal years. While we should try to cram as much as possible into FY2008, realistically half or more of the outlays will probably carry over into FY2009.

What about tailoring the package to current circumstances? Two factors account for most of the current economic weakness. One is that we have been experiencing a rolling "oil shock" for some years now, with oil prices recently touching the $100/barrel mark before receding. The implied "tax" that high oil prices impose on American consumers creates many problems, one of which is that some low-income families have trouble paying their heating bills. The LIHEAP program was explicitly designed to alleviate such hardship, so the current situation strongly suggests expanding that program immediately. As in the case of Food Stamps, more funds for LIHEAP will put money into the hands of those who will spend it quickly—many of whom will not benefit from an income tax rebate.

But the bigger problems for our economy today, as everyone knows, have their roots in the housing and mortgage markets—especially sub-prime mortgages and related financial instruments. The families facing foreclosure (or already in default) on sub-prime

mortgages are primarily low-income households with little or no access to credit. Thus they are precisely the types of households whose spending propensities are likely to be high, and helping them keep their homes should therefore carry high bang for the buck. Unfortunately, we have no pre-existing program, tailored to this constituency, that can be used to funnel payments quickly to those in need.

CBO's excellent recent paper on stimulus notes, quite correctly, that fiscal stimulus need not be applied in the areas in which spending is weakest. That's true. As an example, during 2007 rising net exports helped offset the drain on GDP growth caused by the housing slump. For that reason, CBO says, possible actions "to address problems in the housing and mortgage markets… should therefore be evaluated primarily with regard to their effectiveness in correcting identifiable failures in those markets—and not necessarily with regard to their value in counteracting economic weakness."[10]

Here I'd like to disagree, and CBO gives the reason why in the very next sentence: "Policy actions affecting the housing and financial markets may, however, help the economy by reducing the risks of a self-reinforcing spiral (of less lending, lower house prices, more foreclosures, even less lending, and so on) that could further impair economic activity…" In other words, if we can figure out a way to ease the plight of families who might otherwise lose their homes, we will not only help some people in dire need, but also help the economy avoid a recession and help the financial markets get back

[10] Congressional Budget Office, *Options for Responding to Short-Term Economic Weakness,* January 2008, page 1.

on their feet. I believe that trifecta is sufficiently alluring that we should try for it, even if doing so requires some compromises with our principles of good stimulus design.[11]

But what to do? The House bill is a start, but this is really a question for a separate hearing and a much longer testimony. So let me just close with a few brief thoughts.

First, I am very much in the Alan Greenspan school on this issue. Mr. Greenspan, you may recall, told an interviewer that one useful thing the government can do is send cash. Send cash how? There are a variety of ways. One is cash transfers to help people make their mortgage payments and avoid foreclosure. Another is assistance to state and local governments and community organizations trying to prevent neighborhoods from being blighted by abandonment. A third is to put more counselors and workout specialists in the field to help people avoid foreclosures, perhaps by refinancing on more reasonable terms.[12] And so on.

But, unfortunately, the current financial problems extend well beyond sub-prime mortgages and, indeed, well beyond mortgages more generally. The credit and fixed income markets are in a tizzy, with some of them barely functioning. As Federal Reserve Chairman Bernanke has noted, these problems in the credit-granting mechanism pose a grave threat to the entire economy. Indeed, I think that is what is mainly motivating the Fed to cut interest rates so rapidly. My personal worry is less about recession and more about our economy's ability to mount a vigorous recovery unless the dysfunctional credit markets are repaired.

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[11] The main compromise is that we will probably have to create new programs rather than utilize pre-existing ones. That said, long-established agencies like the FHA, Fannie Mae and Freddie Mac are probably well-positioned to help out.

[12] Substantial value is lost whenever a foreclosure takes place. It is therefore in the interests of *both* the homeowner *and* the mortgage holder to renegotiate the terms in order to keep the homeowner in the house—and making at least *some* payments.

It would be nice to see private capital rush in to do the job. But the crisis is now about six months old, and this does not appear to be happening to any great extent. Instead, extreme risk aversion rules the roost, bid-ask spreads are gigantic, and bargain hunters are scarce. This is a dangerous situation, and that danger leads me to suggest that Congress start thinking about establishing two new federal agencies. One would be somewhat analogous to the Resolution Trust Corporation (RTC), but quite different in details. Its job would be to get the fixed income markets functioning again—and then go out of business. The other would be analogous to the Home Owner's Loan Corporation (HOLC), which existed for three years during the Great Depression. Its job would be the same as it was in the 1930s: to refinance homes to prevent foreclosures.

I wish I was in a position to spell out all the details of these two proposed institutions for you today. But I have had neither the time nor the resources to work out the details. And there is probably no perfect design, anyway. I simply want to plant the thought.

Finally, to link these longer-run ideas about the housing and financial markets back to the stimulus issue, I would urge Congress not to wait for a brainstorm on the sub-prime and broader financial problems. First, let's put a simple stimulus package together as quickly as possible, without any new institutions aimed at the sub-prime problem or the financial markets. Sensible actions on those two fronts are badly needed, but they will take time to develop and implement. Once Congress passes a stimulus package, they should be the next order of business.

Thank you all for listening.