Fiscal Stimulus Issues
Testimony before the House Budget Committee

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I am grateful for the opportunity to testify before this committee at this important juncture. I admire last week's efforts by the President, the Treasury Secretary, and both parties of the House to reach a deal on a stimulus package that is timely, targeted, and temporary. A similar urgency in the Senate this week will hopefully produce the stimulus this economy requires and will help average Americans to get through this period of economic uncertainty. Here I answer six questions concerning the major issues at stake in the debate over fiscal stimulus, and then provide my views on the stimulus agreement reached last week. While I will attempt to provide the most definitive answers as of this moment, the best policy response may change as we receive new economic data and as our understanding of the current, highly volatile economic situation improves.

1. What is the current economic outlook?

Following the instability in global markets last week and recent economic reports – particularly the last employment report and retail sales data – my judgment, like that of many economists, is that a recession is more likely than not. Even if there is not an officially defined recession, there is almost certain to be a significant slowdown in the economy that will feel like a recession in many parts of the country and to many businesses and families. Moreover given the extraordinary fragility observed in financial markets at present, there is a risk of a dangerous situation developing in which financial strains create a weakening economy which in turn creates financial strains. Such a vicious cycle if not preempted could lead to a recession considerably worse than what we observed in in either 2001 or the early 1990s. In this context the preponderant economic risks are of recession and financial instability rather than inflation and asset price bubbles.

2. Why not rely on monetary policy to stimulate the economy and focus fiscal policy on longer term issues?

As Chairman Bernanke has recognized, monetary policy has an essential role to play in maintaining demand and growth as well as in combating financial instability. In the current context, however, it is best complemented by fiscal policy for a variety of reasons: (i) in normal times fiscal policy is faster acting than monetary policy, and given the financial problems it may be even more true today. (ii) proper fiscal policies can target the innocent victims of recession and can directly promote job creation, (iii) full reliance on monetary policy could easily mean lowering interest rates to levels that would be problematic for the dollar, commodity prices, future asset bubbles and moral hazard, and (iv) in a situation where policy impacts are uncertain it is most prudent to rely on a diversified set of stimulus measures. The Federal Reserve's unprecedented 75-basis-point intermeeting reduction constitutes an important step, but the goal of alleviating the likelihood of a recession – and moderating a recession if we do experience one – will be best achieved by complementing monetary policy with a fiscal stimulus. Failure to build on the progress made in the last weeks towards an agreed stimulus plan would be a significant blow to market confidence and economic prospects.

<u>3. How great is the risk of overheating the economy and causing inflation? Should a decision on fiscal stimulus await definitive evidence that the economy is in recession?</u>

The balance of risks is now on the side of recession rather than inflation. Inflation measured by personal consumption expenditures excluding food and energy was 1.9 percent over the last year. Measures of inflation expectations as inferred from Treasury indexed bonds are close to their lowest point in the last two years. Moreover, in a climate of great uncertainty about workers' jobs and firms' profit margins inflation pressures are more likely to diminish than increase. Increases in inflation that have been observed recently reflect to a significant extent the impact of developments in oil as well as other commodity markets as well as declines in the dollar. Even if they are not reversed, these markets are unlikely have as large an inflationary impact in the future as in the recent past.

There is sufficient weakness in the economy to justify stimulus legislation now with provision for rapid implementation. Studies of past experiences with stimulus reveal that too often stimulus comes too late. The risks of excessive delay given lags in implementation and effect are much greater than the risks of premature stimulus. If stimulus were to be excessive any highly speculative risks of overheating the economy could be offset by the Fed. On the other hand, allowing recessionary forces to build could be very dangerous as financial and real economic problems reinforced each other.

<u>4. How large should a stimulus package be?</u>

In December, I advocated stimulus in the range of $50-$75 billion. Given recent data, I now believe that it would be appropriate to enact a program of this magnitude as soon as possible and to make provision for a second tranche of about the same magnitude. While as recently as a few weeks ago, I would have favored some tranching of additional fiscal stimulus, adverse developments have been sufficient that I now believe that enacting a full package at once is the best course of action.

Sizing a stimulus package cannot be reduced to hard science. Given the deterioration in the economy that has taken place in recent months a package with a total cost of 1% of GDP would run very little danger of overheating the economy on any plausible scenario. If delivered in the second and third quarters of 2008 it could have a material impact on consumers and on confidence more generally.

5. What should comprise a stimulus package?

As with any potent medicine, stimulus, if misadministered, could do more harm than good by increasing instability and creating long run problems.

A stimulus program should be timely, targeted and temporary.

Timely stimulus requires both that Congress and the President act quickly and that measures be chosen which can be implemented rapidly and which will have their ultimate impact on spending in short order. This puts a premium on simple measures that work through existing modalities, such as adjustment of withholding schedules, tax refunds, or enhancements of benefits. It calls into question the wisdom of designing new programs or using approaches where Federal spending is not injected fairly directly into the economy. When past stimulus efforts have failed, the major problem has been that they have come too late.

Given the Olympic analogies that been infused into this election cycle in recent weeks, a medal system may be an appropriate rubric for quantifying the relative timeliness of various stimulus packages. A gold medal would go to legislation passed in the first quarter of this year, with its impact realized in the second and third quarters. A silver medal could be awarded for any legislation passed in the second quarter, with impact realized within the year. But because this is an Olympics of a different sort, no medal would be awarded for legislation enacted beyond the second quarter that does not have an impact this year.

Targeted stimulus requires that funds be channeled where they will be spent rapidly and where they will reach those most in need. This also argues for use of simple changes in withholding schedules, or tax refunds, as well as for changes in benefit formulas. In general, targeting in both the sense of assuring maximum spending and fairness are likely to be achieved by measures that focus on those with low incomes and whose incomes have sharply declined.

Temporary stimulus is necessary if stimulus is not to raise questions about the country's long run fiscal position. If stimulus were not credibly temporary, it would likely raise long term interest rates and increase capital costs offsetting its positive impact. Moreover if stimulus is not temporary, the risks that it will continue even after the economy recovers and lead to inflation or very high interest rates is greatly increased. **Stimulus should be designed so that its proximate impact on consumer or government spending is all felt within a year of enactment and in any event by the end of the first quarter of 2009.** If fiscal credibility is to be maintained, it is important also that no measures be enacted on a temporary basis that will generate overwhelming political pressures for their extension.

On the tax side, these considerations suggest the desirability of across-the-board equal tax cuts or refunds for all tax-filers, as the President and House agreed last week. Measures which reduce taxes in proportion to taxes currently paid or that disproportionately favor upper income taxpayers or recipients of capital income are likely to be far less effective because such taxpayers spend much less of new income than low and moderate income taxpayers. Measures which commit today to reduce future taxes relative to current law are likely to be counterproductive because of the fiscal doubts they raise and because they do not provide liquidity now, which is precisely the moment when consumers are facing the need to cut back spending.

From these perspectives, the proposal agreed by the House and Administration is a very valuable step forward. It is timely, targeted and temporary. I believe it could be improved however in two ways:

Business incentives: As I stated previously, the case for business rebates is not compelling. The experience with the 2001 stimulus program is not very encouraging with respect to the efficacy of business incentives as stimulus. Nonetheless, a properly-targeted temporary investment tax credit or accelerated depreciation scheme might pull some investment forward from future years into 2008. To maximize the bang for the buck, such a program should be **incremental** and apply only to investment above some benchmark, such as 2/3 of previous investment or depreciation.

Increases in benefits: The agreement between the House and the President failed to adopt increases in benefits, such as unemployment insurance and food stamps, in spite of significant nonpartisan research championing them as the most efficient stimulus options. A recent study by the Congressional Budget Office found that out of all stimulus options, only unemployment benefits and food stamps were cost-effective in terms of the demand they generate relative to their cost, featured a short lag between enactment and realization of the stimulus effect, and could be predicted to be effective with substantial certainty. Such increases can be implemented quickly, and the benefits go to people who will spend them fast. In addition, these benefits provide assistance to the innocent victims of recession, the people who struggle most to pay heating bills, to pay their monthly credit card bills, and to stay employed so that they can support their families.

6. Should stimulus be paid for within a given budget window?

Fiscal stimulus to an economy in recession operates by increasing demand in an economy that is constrained by lack of demand. If it is paid for contemporaneously, its point is largely lost as there is no net stimulus to demand because money injected in one area is withdrawn in another.

As long as a fiscal stimulus program is temporary and does not create expectations of future spending or tax cuts, it does not make a large economic difference whether or not it is offset by specific future fiscal actions. Including offsets in a five or a ten year window would magnify the impact of fiscal stimulus a little bit by reducing any adverse impact on capital costs because it would avoid any increases in long run debt levels. But it would also run the risk of delay in providing stimulus as the Congress debated possible offsets.

7. What are the most important budgetary issues going forward after the Stimulus Debate

While stimulus is appropriate in the short run, the United States needs over the medum term to restors its fiscal health to the level of the 1990s. Deficit reduction is essential if capital costs are to be low enough to encourage healthy investment in the future of our economy. As part of the concern about deficit reduction, over time it will be necessary for Congress to look at among other things: (i) health care spending on a systematic national basis, (ii) Social Security and its actuarial soundness which has deteriorated in recent years; (iii) budget process issues (iv) tax evasion and avoidance among other things.