

# Commentary: Activist Fiscal Policy to Stabilize Economic Activity

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When Ed Koch was mayor of New York, he would greet constituents with “How’m I doing?” So, too, from our president and his economic team. How is the “stimulus package” doing? Do we need another round? Will America have a lost decade without enhanced fiscal activism?

Alan Auerbach and Bill Gale weigh in on these questions with an excellent addition to this symposium in their paper on activist fiscal policy. Their paper is important for two reasons—first to evaluate recent applications of discretionary fiscal policy, and second to push the profession toward being able to answer more precisely policymakers’ questions about likely changes in consumption, investment, and output in response to discretionary fiscal policy.<sup>1</sup> Many specialists in public economics—including the authors and me—have focused much of their research on effects of long-run tax policy changes on real variables. But political interest in discretionary policy remains high, and policymakers deserve serious answers. The standard answer until relatively recently<sup>2</sup> had a “just say no” quality about it—as will most of my remarks today.

Auerbach and Gale make good progress in their paper in describing the range of answers about effectiveness of fiscal policy, and their review of evidence is valuable. But the paper leaves open as many

questions as it answers. For example: What is the most reasonable assessment of multipliers in the recent stimulus packages of 2008 and 2009? How should one consider “fiscal policy” actions through the financial sector? Are the “lessons” of the U.S. experience in the 1930s and the Japanese experience in the 1990s so clear? And is the desirability of activist fiscal policy influenced by high and rising levels of government debt relative to GDP?

I turn to these questions now.

### **Evidence on Multipliers for Temporary Tax and Spending Changes**

A key element in evaluating output effects of recent attempts at fiscal stimulus in the United States is the value of policy multipliers. My reading of recent research suggests more caution than Auerbach and Gale suggest. A recent paper by the (now) chair of the Council of Economic Advisers, Christina Romer, and Jared Bernstein (2009), using two quantitative macroeconomic models, estimates that a 1 percent increase in government spending would increase real GDP by 1.6 percent.<sup>3</sup> This effect persists because Romer and Bernstein assume that the Federal Reserve continuously holds the federal funds rate at zero. This assumption is inconsistent with a long-run non-inflationary equilibrium. By contrast, Cogan, et al., assumes the federal funds rate to be zero in 2009 and 2010, following a standard monetary rule thereafter. They also use a forward-looking model in which the stimulus spending is paid for by future taxes (conservatively assumed to be lump sum taxes). Three years out, Cogan, et al., estimate a multiplier for government purchases of 0.4, one-fourth the value suggested by Romer and Bernstein.

More important, while these exercises are useful to assess differences across models in effects of permanent changes in government purchases, they are not so close to the final \$787 billion stimulus package signed by President Obama on Feb. 17, 2009. Only \$21 billion of government purchases occurs in Fiscal Year 2009, increasing in 2010, then stabilizing for two years, declining beginning in 2012. The *deficit* path is different because the change was a mixture of increased transfer payments, tax refunds, and higher government purchases. Federal transfers to state and local governments involve some

government purchases (and these transfers exceed federal purchases in the first three years). Both Romer and Bernstein and Cogan, et al., assume that 60 percent of transfers to state and local governments translate to purchases.<sup>4</sup> Cogan, et al., estimate a spending multiplier no more than one-third of that estimated by Romer and Bernstein.

The negative wealth effect of future taxes on consumption and investment in Cogan, et al., is likely conservative, given that the Obama administration has announced its future reliance on *distortionary* taxes on labor income and capital income. Of course, going the other way, the presence of liquidity-constrained households could lead to higher marginal propensities to consume (though such an effect is likely modest if the share of constrained households is relatively low; see Hubbard and Judd, 1986).

Assessing the complete stimulus package requires analysis of the tax provisions as well. Incorporating a modest effect of temporary tax changes on consumption, Cogan, et al., calculate an impact on GDP for the entire package by the fourth quarter of 2010 of 0.65 percent, in contrast to the total effect estimated by Romer and Bernstein of 3.6 percent of GDP.

In addition to these reservations about the size of multipliers associated with the stimulus package, two tax policy concerns arise in any forward-looking model—the relative absence of pro-growth tax changes and (as I noted earlier) the role of future distorting tax increases. More analysis of these alternatives would be useful.

### **Other Aspects of Fiscal Policy and Lessons from Tax Reforms**

A key distinction in the present economic downturn—and a distinction leading to its severity—is the presence of a financial crisis. The elevation of interest rate spreads for all risky lending reduced consumption and investment directly through higher interest rates and, importantly, through declines in credit availability on account of actions of capital-constrained financial intermediaries. (As an example, the spread of 30-year conforming mortgage rates over 10-year Treasury bonds rose from a historical average of 160 basis points to more than 280 basis points in part of 2009, with a large depressing

effect on housing demand, house prices, and the balance sheets of financial institutions (see Hubbard and Mayer, 2009).

Well-designed fiscal interventions to restore the health of financial institutions and reduced credit spreads to levels consistent with the risk of default can have potentially significant effects on output. For example, the Troubled Asset Relief Program (TARP) focused on financial intermediaries, though with halting implementation that likely blunted its early effectiveness. Another fiscal shift could have been to increase federal debt and use conservatorship of Fannie Mae and Freddie Mac to acquire mortgage assets. While the Treasury neglected to pursue this option, the Federal Reserve essentially did. Any attempt to measure effects of fiscal policy in the crisis must focus on such interventions and their effects.

A better role for conventional tax policy would be to focus on good long-term tax design. Auerbach and Gale are right to point out that one cannot use high long-term estimates of tax changes on economic activity; for example, in using tax reforms to identify substantial effects of the user cost of capital on business fixed investment, Kevin Hassett and I (2002) were skeptical that such estimates are useful for assessing temporary tax changes, whose effects are clouded by uncertainty facing decisionmakers. And, as I discussed earlier, temporary tax changes are likely to generate a modest effect on output, while darkening fiscal clouds further.

### **Lessons from the U.S. in the 1930s and Japan in the 1990s**

In the present recession, some policymakers have expressed concerns that fiscal stimulus will be withdrawn too soon, a fear echoing Cary Brown's (1956) classic study of fiscal policy's less-than-stellar role in the 1930s. There are, it seems to me, at least three reasons for skepticism here. The first is that most modern analysis suggests that it is *monetary policy* that played the starring role in reflation and recovery—both actual increases in the money supply and a commitment to end deflation by abandoning the gold standard (see, for example, Romer, 1992). Second, the presence of zero policy interest

rates does not imply central bank impotence, as current quantitative easing makes clear. Third, apart from a lack of “stimulus,” fiscal policy was perverse after the initial recovery, as in the case of the ill-timed Undistributed Profits Tax of 1936-1937, which contracted business investment (cf., current calls to raise capital gains taxes and taxes on earnings of multinational companies).

What of Japan’s “lost decade”? First, monetary policy was perverse for much of the period, allowing deflation and expectations of deflation to take hold. Second, fiscal policy, when tried, was skewed as much or more to public works projects as to tax cuts (and Bayoumi, 2001, finds much longer-lasting multipliers for tax cuts than spending increases) and structural fiscal imbalances and policymakers statements raised the specter of future tax increases from discretionary policy changes, a cautionary tale for the United States today. Indeed, the examples from both the 1930s and 1990s suggest the adverse effects for recovery of expected future tax increases; in that sense, they are directly relevant to the present U.S. situation.

### **Lessons from the Long-Term Budget Outlook?**

And what of the cautionary tale I just mentioned? Last month, I had the pleasure of moderating an event at the Council on Foreign Relations in New York on the stimulus package and the outlook for the federal budget and the U.S. economy with Office of Management and Budget Director Peter Orszag. Knowing that the director is a country-and-western music fan, I asked him if his views called to mind the Johnny Cash line: “I’m just a chunk of coal, but I’ll be a diamond soon.” He, indeed, outlined a path of fiscal rectitude after the stimulus package. But that path is most unlikely, absent much more drastic, forward-looking, long-term action than that contemplated in present discussions.

Auerbach and Gale, with their expertise in public economics and Washington budget experience, drove this point home in an earlier (2009) paper. As Alan and Bill noted there, the federal fiscal picture darkened over the past decade. The budget deficit for Fiscal Year 2009 is very large<sup>5</sup>, and the 10-year projections are very bad.

Their work in that research offers three interesting conclusions about the “long run.” The first underscores the bipartisan tolerance of large deficits. The Auerbach-Gale adjusted baseline, which extends the 2001 and 2003 tax cuts and the AMT provisions, yields a projected deficit of 4.8 percent of GDP in 2012, increasing to 6.4 percent of GDP by 2019. The Obama administration’s budget follows a similar path—projected deficits fall to 4.0 percent of GDP in 2012 and then gradually rise to 5.5 percent of GDP by 2019. The Obama administration’s budget would lead by the end of the 10-year period to a doubling of the debt-to-GDP ratio, with federal spending at its highest level relative to GDP since World War II (and this analysis does not include large changes in spending and deficits accompanying the administration’s recent health-care proposals).

The second codifies the grim reality of the long-term U.S. fiscal outlook, extending the fiscal gap<sup>6</sup> methodology developed by Auerbach (1994). Under the Auerbach-Gale adjusted baseline, the fiscal gap over the infinite horizon is 9.36 percent of GDP. The results under the Obama administration’s budget produce a fiscal gap over the infinite horizon of 8.63 percent. And, in either case, the economy would pass its highest-ever debt-to-GDP ratio (108.6 percent, in 1946) in about 17 years.

The late Chairman of the Council of Economic Advisers Herb Stein famously noted that “something that is growing too fast forever will stop.” And so it must be for fiscally unsustainable budget paths. Hence the third conclusion: We must find a way to close the deficit gap now.

Interest on the government’s existing debt offers the fillip for early action, of course. But the cost of the delay is not simply one of larger outstanding debt balances and interest bills for debt service. While low interest rates would mitigate interest additions to outstanding debt, low interest rates raise the present value of the implicit liabilities in the future.

It is a real question whether this fiscal problem blunts effects of temporary “stimulus” packages. Here again, model specifics matter: Large required changes in taxes or spending would have substantially

different effects on output, well-being, and the fiscal gap itself in most economic models. This point is in high relief when one considers raising taxes in saving and investment (expiration of the 2001 and 2003 tax cuts) versus changing incentives to reduce the growth rate of medical spending.<sup>7</sup> Indeed, using estimates from earlier work by Engen and Skinner (1992), validating the projected spending increases in the long-term budget outlook of the Congressional Budget Office with tax increases could reduce GDP growth by about a full percentage point.

But focusing on future deficits tipping evenly between tax increases and spending restraint calls to mind the alternative country-and-western music line from Toby Keith that I reminded Director Orszag—"There ain't no right way to do the wrong thing."

### **Conclusions and Thoughts for Future Research**

Auerbach and Gale pose two big questions in the paper. First, did we need activist fiscal policy in the present financial crisis? They answer "yes"; I agree, but I think more of fiscal interventions to stabilize the financial sector. Second, were the 2008 and 2009 "stimulus packages" the most effective activist changes? The authors answer "no"; I agree. Of course, there remains a third question: Do we need another stimulus package? I suspect the authors would join me in answering "no."

The Auerbach-Gale contribution to this symposium highlights the potential value of three avenues of future research. First, the range of estimates for multipliers of fiscal policy changes is unsettling to policymakers and should be to us. Second, we need to assess theoretically and empirically the consequences of fiscal interventions through the financial sector of the economy. Third, we need to assess constraints on discretionary fiscal policy from elevated levels of government debt. Such work could address how agents form their expectations of future policy, how measures of fiscal distress affect economic variables (that is, through interest rates and accompanying effects on asset prices or through effects of higher future tax rates on forward-looking decisions).

Maybe another New York mayor, Fiorello LaGuardia, got it right on consequences of too much stimulus: “We have had two chickens in every pot, two cars in every garage, and now we have two headaches for every aspirin.”



## Endnotes

<sup>1</sup>A wide range of multiplier estimates is not, by itself, the problem, as multipliers will likely vary over the cycle. But largely atheoretical exercises make it difficult to account for differences and conduct rigorous forward-looking policy analysis.

<sup>2</sup>Most recently, see Cogan, et al. (2009), and Taylor (2009); for a contrary view, see Romer and Bernstein (2009).

<sup>3</sup>This estimate stands in contrast to the negligible long-run effect estimated by Taylor (1992). Hall (2009) argues a consensus estimate for the government purchases multiplier of about 0.75.

<sup>4</sup>There is little evidence historically that transfers from the federal government to state and local governments raise spending, all else equal.

<sup>5</sup>And the full effects of the financial crisis have likely not been felt. Reinhart and Rogoff (2008a, 2008b) provide compelling evidence using data over time and across countries that financial crises increase government debt substantially—an average of 86 percent. These increases reflect not so much “bailout” funds as consequences for revenue of lower output and costly countercyclical policies.

<sup>6</sup>The fiscal gap represents the immediate and permanent increase in taxes or reduction in spending required to restore fiscal balance.

<sup>7</sup>This point applies to the Bush administration as well as to the Obama administration. The dividend and capital gain tax cuts of 2003 had both efficiency gains and substantial positive feedback effects on revenue—not so, the costly addition of the Part D benefit to Medicare. In a (2005) paper, I estimated that even a debt-financed elimination of the double taxation of corporate equity capital would increase the level of potential output permanently by 0.48 percent, making possible a significant reduction in revenue cost (see also U.S. Department of the Treasury, 2003).

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