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As the world's economy has entered a dramatic slowdown, there has been an interesting policy revolution. Up until recently, there was wide consensus among macroeconomists that activist fiscal policy was inadvisable. Blinder (2004), in a now prescient piece, began his reconsideration of the case against fiscal policy with the statement that "virtually every contemporary discussion of stabilization policy by economists—whether it is abstract or concrete, theoretical or practical—is about monetary policy, not fiscal policy."[1] Taylor (2009) alludes to a similar consensus, referring to his own earlier work (Taylor 2000), to Feldstein (2002), and to Eichenbaum (1997), who quite pointedly added that, "there is now widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible."[2] These reviews generally found that stimulus had not been effective in the past and usually appeared at the incorrect time.

Despite these admonitions, there is one thing that appears certain as of this writing: Countercyclical discretionary policy is now politically feasible. In the United States, and around the world, significant temporary stimulus packages are being drawn up. In the United States, government economists have even gone so far as to assert that stimulus actions have the consensus support of economists. In a recent article in the New York Times, for example, Christina Romer, chairwoman of the Council of Economic Advisors, said that "aggressive, well-designed fiscal stimulus is critical to reversing this

[1] Blinder (2004), p. 1.
[2] Taylor (2009), p.2.

severe decline." The article then continued "that the vast majority of the nation's economists agree that one is necessary, and soon."[3]

The purpose of my testimony is to argue that this, along with many other statements concerning the "majority of economists," is at the very least an interpretation that is subject to debate.

In the past, economists likely opposed stimulus because they believed that it could not be passed at the correct time, and it might not be effective. On the latter point, there is a vast literature consisting of (at least) two schools, the "Keynesians" and the "Neoclassicals," such as Harvard economist Robert Barro. A rough read of that literature suggests that Keynesians would agree with Ms. Romer while Neoclassicals would not. My reading of the empirical literature is that it favors the Neoclassicals.

As for the timing, we have new evidence on that. A stimulus bill has passed the House of Representatives and is wending its way through the Senate. This is the second attempt at stimulus since the beginning of the recession, which, according to the NBER Business Cycle Dating Committee, occurred in December, 2007.[4] President Bush signed the Economic Stimulus Act of 2008 on February 13 of last year.

Financial markets, which have clearly suffered their worst decline since the Great Depression, have signaled the strong expectation that this downturn will be long and deep. If the recession matches the longest on record, and lasts 16 months, then it will end before the summer of 2009. Given the desperate financial crisis, however, such an early end to the recession seems far from likely. Indeed, two recent studies of past financial

[3] in Louis Uchitelle, "Steep Slide in Economy as Unsold Goods Pile Up," New York Times, January 30th, 2009.
[4] http://www.nber.org/cycles/dec2008.html.

crises (Reinhart and Rogoff 2008) suggest that crises of this form tend to last significantly longer. Accordingly, one can say that the timing of the first package has little chance of being procyclical, and should be viewed as a timing success.

The second package may or may not be viewed as a timing success. According to a report by the Congressional Budget Office, the stimulus package spreads its positive stimulus out over a fairly lengthy period.[5] For example, the bill calls for $30 billion in highway spending, but the CBO estimates that less than $4 billion would occur before 2011. Similarly, only about $10 billion of the approximately $33 billion in spending on renewable energy and school construction will occur over the next two years. Thus, recent actions have not clearly demonstrated that the age-old timing criticism no longer applies. It will depend on whether we have a recession that is the longest we have seen in the post-war period, or something worse than that.

In terms of targeting, the stimulus package allocates, again according to the CBO, about 22 percent of its cost to tax reductions, with the remaining portion representing spending increases. In addition, built in stabilizers and previous legislative actions have ratcheted spending up a significant amount.

In thinking through the economic effects, it is a good idea to begin by putting the numbers in historical context. Figures 1 and 2 document the total tally for recent fiscal policy efforts. Figure 1 compares the current path of government spending in the U.S. to that in previous recessions, while Figure 2 compares the likely tax reduction to that in previous recessions. Both charts suggest that the movements in this downturn are

[5] http://www.cbo.gov/ftpdocs/99xx/doc9976/hr1aspassed.pdf

significantly greater than any in post-war U.S. experience. Accordingly, the complaint that fiscal policy action will be ineffective because it is too small seems less applicable in the current episode.

But would this measure be effective?

Figure 3 provides evidence that motivates the key finding in a large literature that has looked into the impact of stimulus on aggregate activity. The grey bar in the chart is "what you owe," which is my estimate of the expected taxes that each taxpayer shall have to pay in the future to pay off the large upspike in the deficit that is projected to occur this year. The black bar, "what you get," indicates the value of the tax break that the President's version of the stimulus bill calls for.

The question is simple: why would anyone looking at these two bars in the chart ratchet their consumption up today, even if they got a few hundred dollars in cash? Clearly, as individuals look forward to the long run costs of current policies, they will take actions that will offset the stimulus effects, probably to a good degree.

Indeed, while the literature is clear that government spending in the short run can stimulate output, in the long run it is a negative. Barro (1989, 1991) examines the impact of government consumption and investment spending on economic growth in a series of cross-country growth regressions. He concludes that public consumption spending has a robust negative relationship with growth and investment while public investment spending has an insignificant effect on economic growth. Grier and Tullock (1989) find that a one standard deviation increase in government growth reduces average GDP growth by 0.39 percentage points. In other words, there is a strong negative effect of the growth of government consumption as a fraction of GDP. Alesina, et. al. (1999) find similar negative results of government spending on economic performance, as measured by business investment, in an analysis of OECD countries. Fölster and Henrekson (1999) find a negative growth effect of large public expenditures in cross-country analysis.

So at best you have a near term positive impact, followed by long run costs. But when countries are in tough fiscal circumstances, there is even evidence that tightening government's belt can actually be stimulative.

Giavazzi and Pagano (1990) began the on impact of fiscal contractions. They found that in some cases, the first identified were Ireland and Denmark, a country can have a dramatic reversal in economic growth when it achieves a successful fiscal consolidation, that is, when it cuts rather than increases government spending, and raises rather than lowers taxes. Similar results have been found for other countries by Alesina and Perotti (1997), Alesina and Ardagna (1998), and Alesina, Perotti, and Tavares (1998). These effects do not always occur, but they do regularly.

It is necessary, of course, to attempt to find a roadmap that allows one to predict when a country can expect a non-Keynesian effect of a fiscal consolidation, and when it can not. Sutherland (1996) finds that Keynesian effects seem to be most likely when a government begins the episode with relatively low debt, which hardly explains the circumstances we see today. Jönsson (2007) finds that a consolidation is most likely to stimulate growth if it cuts transfers.

Reading through the literature, it is clear that fiscal consolidations can be stimulative, and even when they are not, their presence provides a significant challenge to Keynesian models with large multiplier effects.

Summing Up

Since the short run effects of Keynesian policies are uncertain, and the long run effects are possibly negative, then one might wonder whether on balance, activist countries are serving their citizens. One study that looked at this big picture question is Fatas and Mihov (2003). Looking at a panel of 91 countries, they found that:

> "(1) governments that use fiscal policy aggressively induce significant macroeconoimc instability;
>
> (2) the volatility of output caused by discretionary fiscal policy lowers economic growth by more than 0.8 percentage points for every percentage point increase in volatility."

Hemming, Mahfouz and Schimmelpfennig (2002) provide a useful complementary case history of past recessions. They gather data on all OECD recessions between 1971 and 1998. They find that the impacts of expansionary policy were barely noticeable, and may, at times, have been negative. Consistent with the pattern one would expect from the fiscal consolidation literature, they find that countries with high debt positions that pursued fiscal expansions in their recessions on average saw their economy drop 4.3 percent during the recession in question. Countries that had high debt positions and contracted their fiscal position posted growth rates of 3.8 percent.

These results accord with the intuition one can draw from Figure 3.   When large future expected taxes add uncertainties to the economy, it is difficult for government to fix things without first addressing that major problem. Accordingly, a more cautious read of the literature, one that might even attract a majority of economists, would lean more on measures today that are stimulative, but also address in some way long run imbalances. Examples of programs that might meet such a test include a change in the indexing of long run Social Security benefits in a manner that improves the long run fiscal balance, while also recycling of some of those revenues back into the current economy through something like a payroll cut.

We are fooling ourselves if we pretend that transitory fixes are enough in these difficult times. It is hard to see how firms and individuals will turn optimistic if they see a government that continues to ignore long run challenges, and seek short run and easy fixes.

Figures

Figure 1.

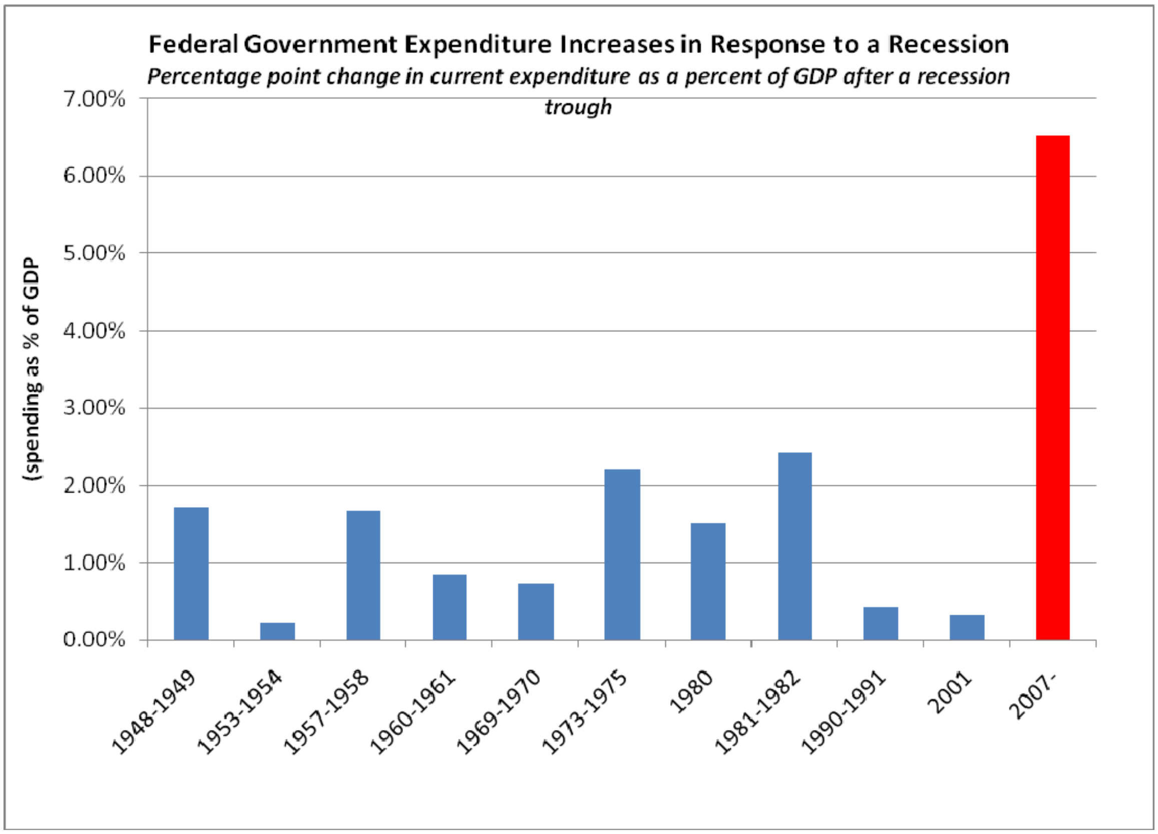
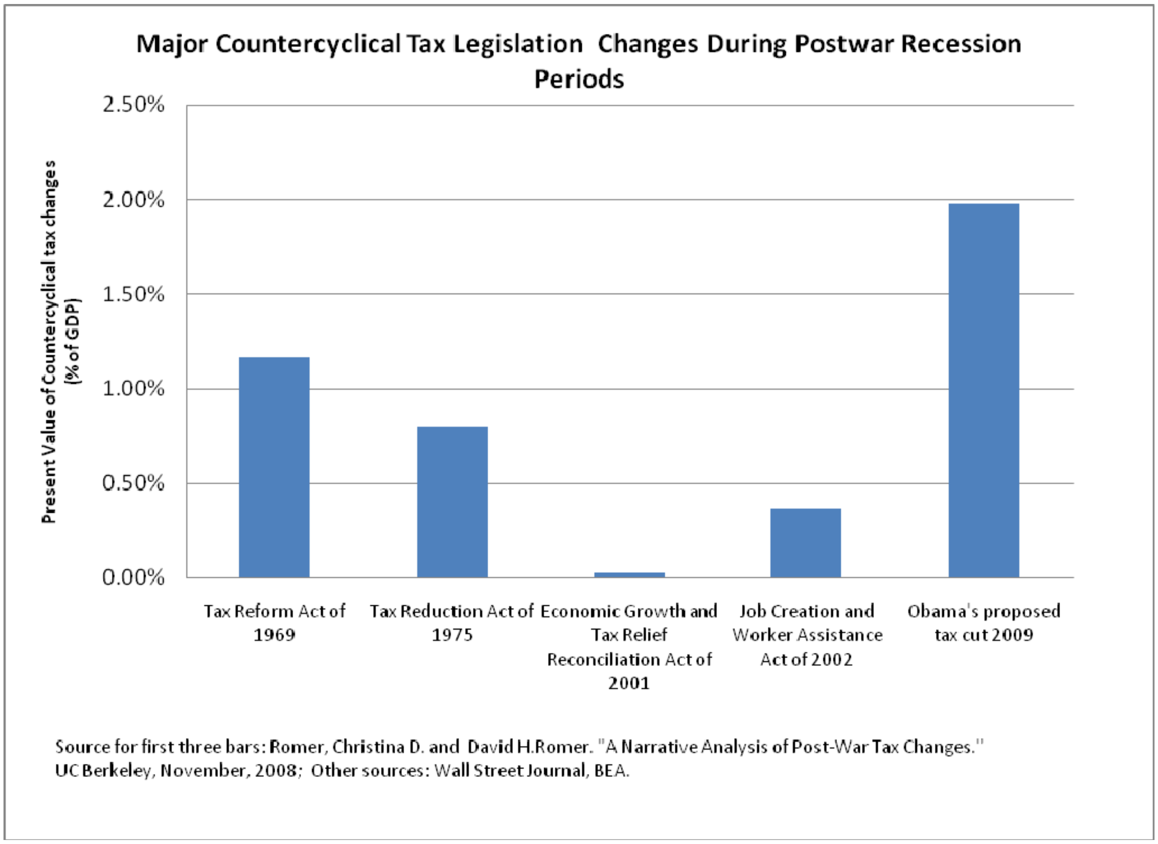
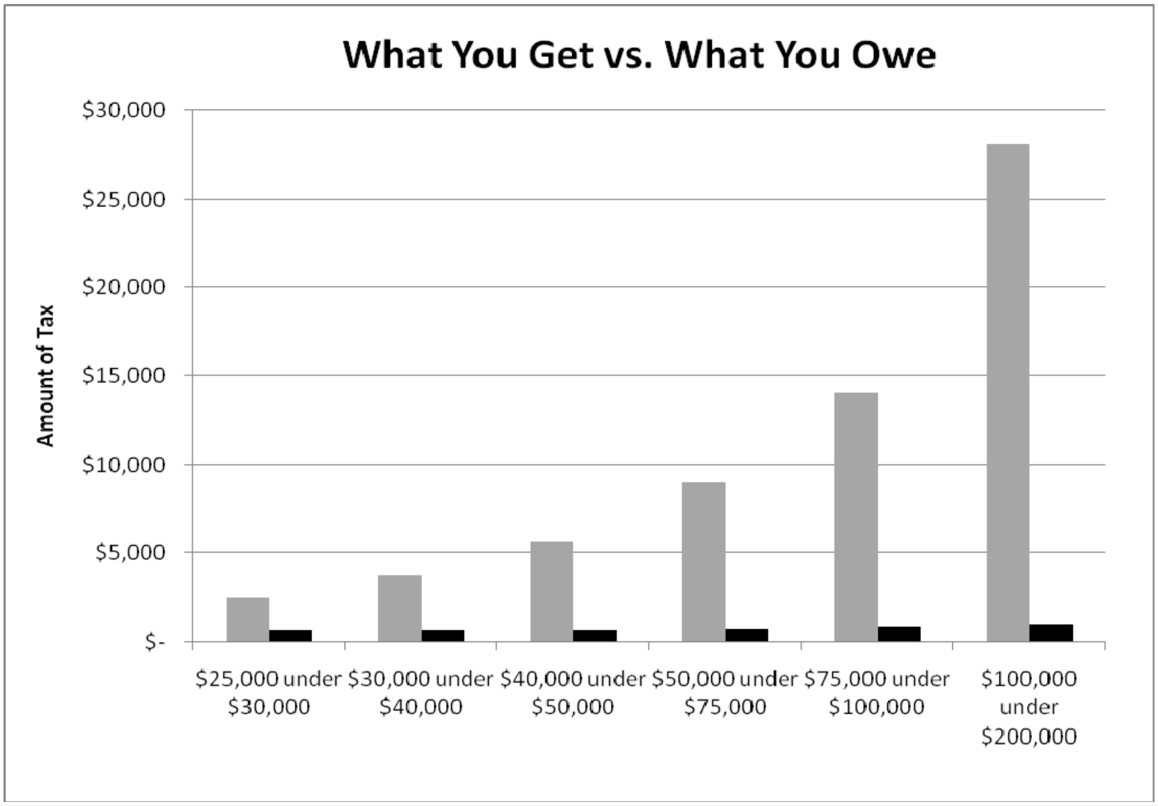


Figure 2.



Major Countercyclical Tax Legislation Changes During Postwar Recession Periods
Present Value of Countercyclical tax changes (% of GDP)
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
Tax Reform Act of 1969
Tax Reduction Act of 1975
Economic Growth and Tax Relief Reconciliation Act of 2001
Job Creation and Worker Assistance Act of 2002
Obama's proposed tax cut 2009
Source for first three bars: Romer, Christina D. and David H.Romer. "A Narrative Analysis of Post-War Tax Changes." UC Berkeley, November, 2008; Other sources: Wall Street Journal, BEA.

Figure 3.



Sources: Author's calculations based on data from the Brookings-Urban Tax Policy Center and IRS Statistics of Income.Notes: income categories are based on adjusted gross income for tax year 2006; income tax amounts are based on "income tax credits." Incomes below $25,000 are assumed to have zero or negative income tax liability; A $1.7 trillion deficit for 2009 is assumed for future tax burden calculations. Red bars indicate the the additional tax burden associated with this year's projected deficit for each income category. The deficit is distributed across tax payers according to the distribution of 2006 tax liabilities. If the distribution of the income tax is unchanged, and the deficit is ultimately paid for via income taxation, then the table indicates the additional burden associated with this year's projected deficit. Black bars show the distribution of federal tax change from The American Recovery and Reinvestment Tax Act of 2009, H.R. 1., as calculated by the Brookings-Urban Tax Policy Center.

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