

Testimony Submitted to the
Senate Republican Policy Committee

February 2, 2009

Alan D. Viard
American Enterprise Institute

Alan D. Viard is a Resident Scholar at the American Enterprise Institute. The views expressed in this testimony are solely his own and do not necessarily reflect the views of the American Enterprise Institute or any other institution or person.

Chairman Ensign and members of the Committee, it is an honor to appear before you today to discuss economic stimulus plans.

The United States is mired in a severe recession. The unemployment rate rose from 4.4 percent in March 2007 to 7.2 percent in December 2008 and nonfarm payrolls shed 2.6 million jobs from December 2007 to December 2008. Economic indicators make clear that the recession will continue for at least a number of months.

Although monetary policy and automatic fiscal stabilizers are usually the best ways to stimulate aggregate demand, current circumstances warrant the adoption of tax and spending measures to further boost aggregate demand. Proper timing is required, however, to ensure that fiscal stimulus stabilizes rather than destabilizes the economy. Personal and business tax cuts and increases in transfer payments can provide a timely boost to consumer spending and investment. Those government purchases that can be spent quickly in a cost-effective manner, such as repairs and maintenance, can also play a useful stimulus role.

Many types of government purchases of goods and services, including most infrastructure construction, cannot be done in both a cost-effective and timely manner. Those types of government purchases should not be included in a stimulus package; if they are desirable investments, they should be enacted through the normal legislative process. Buy-American provisions and rules requiring the payment of above-market wages should be strictly avoided.

Even a properly designed stimulus package will add to the debt burden, aggravating the long-run fiscal imbalance. At the same time that stimulus is adopted, therefore, measures should be taken to address the nation's long-run needs. A bipartisan commission should be formed to address the long-term fiscal imbalance.

I expand on these general points below.

NATURE OF DEMAND STIMULUS

Throughout this testimony, I use the term “stimulus” or “demand stimulus” to refer to policies that increase aggregate demand. Fiscal stimulus refers to tax and spending policies that boost aggregate public and private spending – consumer spending, business and residential investment, government purchases, and exports (net of imports) – at a given level of the interest rate. Monetary stimulus refers to an increase in the money supply, which is manifested in an interest-rate reduction that increases the level of private spending.

A policy that stimulates aggregate demand may, but need not, promote economic efficiency and long-run growth. Aggregate demand can be boosted by growth-promoting policies such as investment incentives or by growth-reducing policies such as incentives to consume rather than to save. As explained below, aggregate demand measures can stabilize the economy, but have little effect on the average level of output.

The most useful way to classify fiscal stimulus measures (considerably more useful than the simple tax-spending distinction) is into the following three categories:

- Disposable income can be increased through tax cuts or transfer payments (or refundable tax credits that blur the distinction between the two). The increase in disposable income may result in an increase in consumer spending.
- Government purchases can be increased to directly boost aggregate demand.
- Timing incentives can be adopted to reward spending during the duration of the recession. A prime example is a tax incentive that applies only to investment during a specified (recessionary) time period.

Federal grants to state and local governments are not a separate fourth category; they boost aggregate demand, if at all, only through the above categories. The grant itself is merely a payment from one government to another, which (like a transfer of funds from one federal government bank account to another federal government bank account) does not directly change aggregate demand. Of course, grants often prompt state and local governments to adopt tax cuts, transfer payments, or increases in government purchases, which then boost aggregate demand.

During recessions, aggregate demand is stimulated by automatic fiscal stabilizers, the tendency of tax receipts to fall and transfer payments to increase when incomes decline and jobs are lost.

POTENTIAL STABILIZING ROLE OF DEMAND STIMULUS

In a frictionless world, changes in aggregate demand would have limited impact on output and job creation and would primarily affect the price level. Most economists have, however, rejected this frictionless model in favor of models in which prices or nominal wages or both may respond sluggishly to changes in the economy. In these models, often referred to as New Keynesian models, changes in aggregate demand, whether implemented through monetary or fiscal policy, have an impact on output and jobs.

Nevertheless, the nature of this impact is limited. Changes in aggregate demand can stabilize output, but cannot permanently increase it. Although an increase in aggregate demand today boosts output today, it has offsetting future effects.

Although economists do not fully understand how changes in aggregate demand affect the economy, theory and statistical evidence suggests that the relationship between output fluctuations and inflation is well described by an “accelerationist Phillips curve.” When that type of relationship holds, changes in aggregate demand have a particularly limited role, assuming that the Federal Reserve does not change the long-run inflation rate.

Suppose that the economy experiences a decline in aggregate demand, such as a reduction in consumption and housing investment caused by a collapse in home prices or a fall in exports due

to economic weakness abroad. Initially, the demand reduction causes a decline in output, along with a reduction in inflation. Later, however, as the Federal Reserve returns inflation to its original level, there is a temporary output gain. This pattern of effects is undesirable because it makes the economy less stable, with particular hardships for workers who lose jobs during the period of output decline.

The proper goal of fiscal stimulus is to undo this destabilization of the economy. If fiscal stimulus is adopted during the period of weakness, it can reverse the output decline, making output higher than it otherwise would have been. Doing so, however, also reverses the subsequent output gain, making output lower than it otherwise would have been.

In this context, demand stimulus does not produce a permanent output gain. It does not even produce a one-time temporary gain that simply fades away. Instead, it produces a temporary output gain that is subsequently “paid back” through a temporary output loss. Even so, it can play a highly beneficial role by stabilizing the economy.

PROPER TIMING IS ESSENTIAL FOR DEMAND STIMULUS

The need for proper timing is clear once the role of demand stimulus is understood. If demand stimulus provided a “free” output gain, it would be useful to get it whenever we could, although we would still prefer to get it when the economy is weak. Under that assumption, timing would be desirable, but not essential. Because the output gain must be paid back, however, it is imperative that the output gain arrives when the economy is weaker and that the subsequent payback occurs when the economy is stronger. Only then does aggregate demand play a stabilizing role. Poorly timed stimulus is actually counterproductive because it destabilizes the economy.

To be sure, it is not strictly necessary that the output gain arrive before the recession ends. The output gain should arrive during a period of *low* output (relative to an appropriate trend measure), not necessarily during a period of *declining* output, the standard definition of a recession. Shortly after a recession ends and an expansion begins, output is still low (although it has started to rise) and that period is therefore still an appropriate time for stimulus to increase output. Clearly, however, the output gain should not arrive too late in the expansion.

Monetary policy is generally the most attractive way to alter aggregate demand because it can react quickly to new economic events. Its principal drawback is that there may be long lags before interest rate changes actually alter aggregate demand. The automatic fiscal stabilizers are also attractive because they react instantly and may affect the economy quickly.

In many recessions, it is sufficient to rely on monetary policy and automatic fiscal stabilizers. Indeed, trying to adopt additional fiscal stimulus through the legislative process has often proved counterproductive due to the lags in adopting legislation.

Nevertheless, discretionary stimulus can be useful, particularly when monetary policy has reduced short-term interest rates to their minimum value of zero and the recession is severe and long-lasting. Those conditions now hold, making fiscal stimulus legislation a reasonable response.

DEMAND STIMULUS AND LONG-RUN POLICY

Long-run policy should be designed to promote economic efficiency, not to increase aggregate demand. Confusing the two goals can lead to serious policy errors.

Consider, for example, a tax policy that permanently increases consumer spending at the expense of saving. Such a policy is highly pernicious because it amplifies the existing tax penalty on saving and damages long-run growth by impeding capital accumulation. The view that the policy must be beneficial because it boosts aggregate demand is profoundly mistaken. It is even a mistake to think that the boost to aggregate demand is a long-run benefit that must be weighed against the long-run efficiency costs. In reality, the permanent increase in aggregate demand offers no long-run benefit at all.

The reason, again, is that the role of demand stimulus is to stabilize the level of output. A permanent stimulus that applies both when the economy is strong and when it is weak serves no stabilization purpose and is therefore useless.

Of course, a policy that happens to permanently boost aggregate demand can be beneficial for other reasons. A tax policy that permanently boosts investment at any given interest rate, for example, is beneficial because it offsets the existing tax penalty on saving and investment and promotes long-run growth by facilitating capital accumulation. But, the benefits from this policy have nothing to do with the fact that it happens to boost aggregate demand.

This reasoning implies that long-run increases in a category of public or private spending cannot be justified on the premise that the spending will add to aggregate demand and thereby create jobs. This point applies to infrastructure spending, military spending, spending on renewable energy, or any other category of public or private spending.

As discussed above, a permanent boost in consumer spending does not serve a useful stabilization purpose. Two kinds of changes could serve a stabilization purpose:

- An ongoing “countercyclical” policy that boosts consumer spending when the economy is weak and depresses it when the economy is strong
- A one-time policy tailored to current circumstances, i.e., a temporary one-time increase (decrease) in consumer spending if the economy is currently weak (strong)

A one-time change could be a freestanding temporary policy, such as tax rebates or temporary credits or bonus depreciation. Alternatively, it could be a delay or acceleration of a permanent

policy adopted for other reasons. For example, a reduction in the corporate tax rate that would otherwise be made at the beginning of 2011 could be moved to the beginning of 2009. The change made for stimulus reasons would be the reduction in 2009 and 2010, which could boost investment demand during the weak economy in those two years. The permanent reduction in the corporate tax rate would not be adopted to stimulate aggregate demand, but would instead be adopted to improve long-run growth by facilitating capital accumulation.

One-time measures adopted for stimulus reasons may have negative long-run consequences. Notably, spending or tax cuts adopted during a recession leave behind a higher debt load. That suggests the need for caution in adopting such policies.

MANY TYPES OF GOVERNMENT PURCHASES ARE HARD TO TIME PROPERLY

Conceptually, it is easy to imagine a stabilization role for government purchases of goods and services. An ongoing countercyclical policy would increase government purchases when the economy is weak and reduce them when the economy is strong. A one-time change would increase government purchases during the current recession, possibly by accelerating government purchases that would otherwise be made later.

The problem, however, is that many types of government purchases, particularly infrastructure spending, are hard to time properly. The Congressional Budget Office (CBO) made this point in a January 2008 report:¹

[B]ecause many infrastructure projects may take years to complete, spending on those projects cannot easily be timed to provide stimulus during recessions, when are typically relatively short lived ... Federal, state, and local governments are responsible for large swaths of the economy's capital stock, which includes ports, bridges, and roads. Those responsibilities also include various forms of reconstruction, such as in areas badly damaged by natural disasters. Proposals also exist for large-scale government investment in new technologies, such as new-generation power plants, facilities that produce alternative fuels, and automobiles that use alternative fuels. Conceptually, spending on these kinds of projects seems to offer an appealing way to counteract an economic downturn ... Practically speaking, however, public works projects involve long start-up lags. Large-scale construction projects of any type require years of planning and preparation. Even those that are 'on the shelf' generally cannot be undertaken quickly enough to provide timely stimulus to the economy. For major infrastructure projects supported by the federal government, such as highway construction and activities of the Army Corps of Engineers, initial outlays usually total less than 25 percent of the funding provided in a given year. For large projects, the initial rate of spending can be significantly lower than 25 percent. Some of the candidates for public works, such as

¹ "Options for Responding to Short-Term Economic Weakness," January 2008, pp.8, 19, 22 (http://www.cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf).

grant-funded initiatives to develop alternative energy sources, are totally impractical for countercyclical policy, regardless of whatever other merits they may have. In general, many if most of these projects could end up making the economic situation worse because they would stimulate the economy at the time that expansion was already well underway. (emphasis added)

In a table summarizing stimulus options, CBO therefore lists “Investing in Public Works Projects” as having “small” cost-effectiveness and a “long” lag from enactment to stimulus.

A similar view was expressed in a January 2008 article by Douglas W. Elmendorf and Jason Furman, who were then at the Brookings Institution:²

[A]dditional physical and technological infrastructure investments ... are difficult to design in a manner that would generate significant short-term stimulus. In the past, infrastructure projects that were initiated as the economy started to weaken did not involve substantial amounts of spending until after the economy had recovered. However this approach might be more useful if policies could be designed to prevent cutoffs in ongoing infrastructure spending (such as road repair) that would exacerbate an economic downturn.

Similar concerns were expressed by Alan S. Blinder of Princeton University, who served on President Clinton’s Council of Economic Advisers from January 1993 to June 1994 and served as Vice Chairman of the Federal Reserve Board of Governors from June 1994 to January 1996. In a 2004 paper, Blinder wrote:³

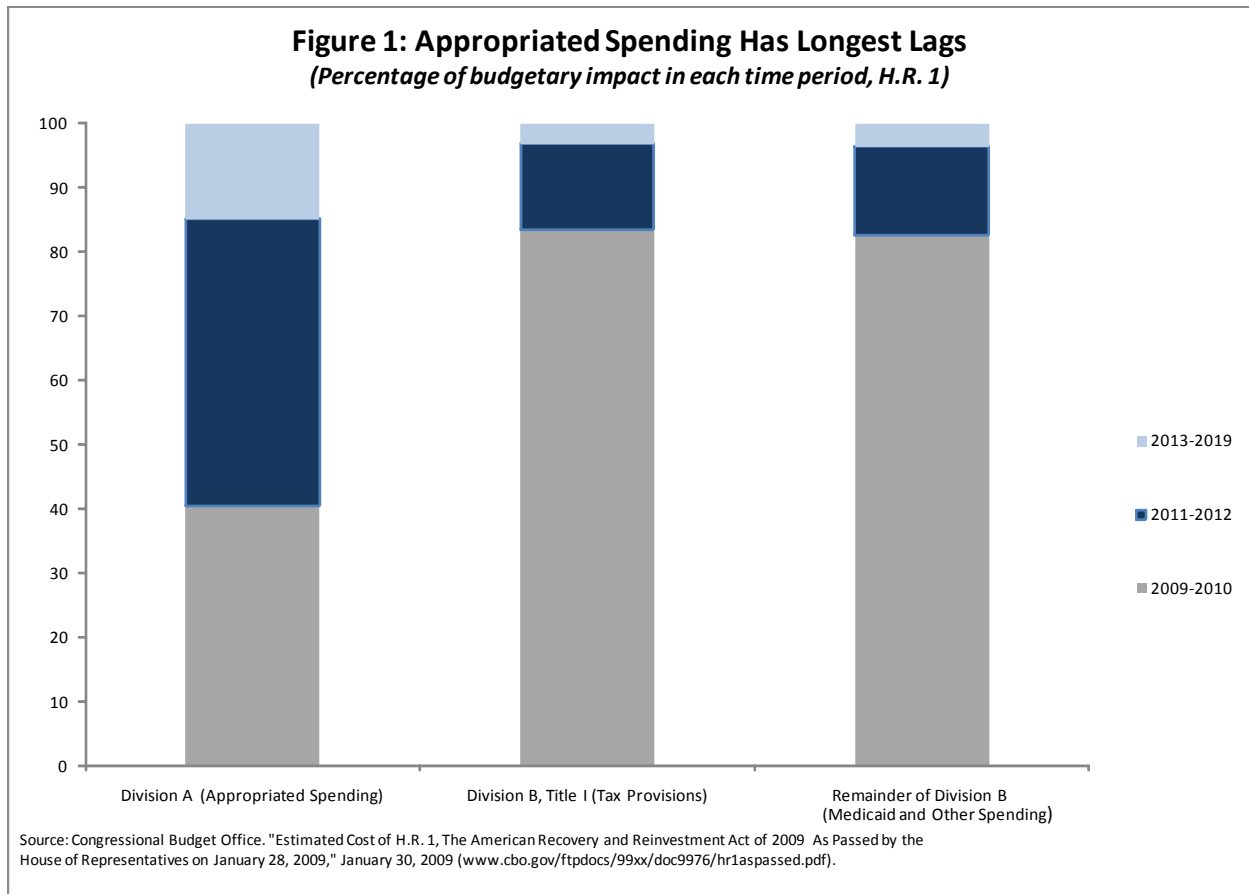
The major objections to using public expenditures as a countercyclical weapon seem to be more practical than theoretical. But I think they are powerful nonetheless ... there are normally quite lengthy lags in the political process before new spending projects are authorized by Congress. Then, since authorizing committees and appropriating committees are different, still more time elapses between legal *authorization* and the actual *appropriation* of funds ... And even if the lags in the authorizing and appropriating processes could be completely eliminated, the slow natural spend-out rates of most public infrastructure projects remains a serious handicap. For example, out of each \$1 appropriated for highway expenditures, less than one-third is likely to be spent within a year. Accelerating the pace of spending on public works for stabilization purposes would be inefficient and wasteful. (emphasis in original)

This is not merely a theoretical point. The slow spend-out rate of government purchases can be seen in CBO’s analysis of H.R. 1, the stimulus bill passed by the House of Representatives on

² “If, When, How: A Primer on Fiscal Stimulus,” *Tax Notes*, January 28, 2008, pp. 545-559, at p. 556.

³ “The Case Against the Case Against Discretionary Fiscal Policy,” Princeton University, Department of Economics, Center for Economic Policy Studies Working Paper 100, June 2004, pp. 27-28 (<http://www.princeton.edu/~ceps/workingpapers/100blinder.pdf>).

January 28. Division A of the bill consists of provisions related to appropriated spending, generally comprising purchases of goods and services. As shown in **Figure 1**, only 40 percent of the budgetary impact of these provisions occurs in fiscal 2009 and 2010. In contrast, 83 percent of the budgetary impact occurs in that time period for Division B of the bill. That holds true for both Title 1 of Division B, which contains the tax provisions, and the remainder of Division B, which contains provisions for Medicaid and other spending (primarily related to transfer payments).



As Elmendorf and Furman noted, slow spending rates do not apply to all categories of government purchases or even to all types of infrastructure spending. For example, repair and maintenance spending can often be done quickly. (Indeed, the Congressional Budget Office's detailed breakdown of H.R. 1 reveals enormous variation in spending rates across different spending items within Division A of the bill). Spending categories that can be spent quickly in a cost-effective manner can play a stimulus role.

It is also crucial that spending be done in the most efficient manner possible. Two provisions in H.R. 1 are antithetical to that goal; the imposition of Davis-Bacon rules requiring the payment of above-market wages and Buy-American provisions that require the use of domestic production

inputs in some cases in which imported inputs would be less costly. The Buy-American provision is also likely to trigger retaliation by our trading partners.

Of course, some government purchases may well be beneficial investments, even if they cannot be spent quickly. If so, they should be adopted through the ordinary budget process rather than rushed through as part of emergency stimulus legislation.

POLICY FOR THE SHORT RUN AND THE LONG RUN

The stimulus legislation should be limited to those measures that can have a relatively rapid impact on aggregate demand and can therefore play a useful stabilization role. Tax cuts and transfer payments can be disbursed quickly and can boost aggregate demand, either by increasing disposable income and thereby boosting consumption or by providing an incentive to accelerate investment. Some types of appropriated spending can also be spent relatively quickly in a cost-effective manner. But, the remaining appropriated spending should be removed from the package, thereby significantly reducing its size. All Buy-American and Davis-Bacon provisions should also be removed.

These changes would preserve most of the stimulative effect of the package while reducing future debt burdens. Even so, the stimulus package will add to the debt burden on future taxpayers. To offset this burden, Congress and President Obama should agree to appoint a bipartisan commission to address the long-run fiscal imbalance. The commission would recommend a legislative plan that Congress would then vote to accept or reject. The commission would be similar in intent to that proposed by Senators Kent Conrad (D-North Dakota) and Judd Gregg (R-New Hampshire) in S. 2063 in the 110th Congress. If such a provision cannot be finalized in time to include in the stimulus bill, it should be adopted soon thereafter.

By adopting an appropriately limited and effectively designed stimulus package while addressing the long-term fiscal imbalance, Congress and the president can promote both the short-run and long-run wellbeing of the American people.