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Fiscal Policy Reconsidered

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Fiscal Policy Reconsidered

The lengthy struggle to emerge from the Great Recession has led to a serious rethinking of a previous verdict: that the job of stabilization policy, with its goal of achieving full employment and low inflation, could and should be left exclusively to monetary policy. Fiscal policy, it had previously been concluded, was too slow, too clumsy, and too political to be relied on, and central banks were ready, willing, and able to do the job.

This view has since been challenged. In a new Hamilton Project policy proposal, Alan S. Blinder of Princeton University reassesses the role of fiscal policy, proposing a series of reforms and best practices to guide the use of fiscal stimulus, or tax cuts and additional government spending, during the next economic downturn. Noting that conventional monetary policy, which consists chiefly of manipulating interest rates, would be relatively ineffective in the event of a new recession given the very low interest rates now prevailing, Blinder argues that policy makers will have little choice but to consider fiscal stimulus. He also points to evidence that monetary and fiscal tools amplify each other's effects, strengthening the argument for using both to alleviate a recession.

In his proposal, Blinder identifies opportunities for improving fiscal stimulus on both the tax side and the spending side. When cutting taxes to stimulate the economy, Blinder calls for Congress to make income and business tax cuts temporary, encourage states to implement temporary sales tax cuts, and make tax cuts automatic to reduce the lag time between recessions and stimulus. When increasing spending, Blinder proposes that Congress expand targeted transfer programs, grants to states and municipalities, and infrastructure spending (with a focus on shovel-ready projects and bonds that make it easier for states to finance new development). He also calls for Congress to encourage more consumer-directed discretionary spending, similar to the successful Car Allowance Rebate System, known as the Cash for Clunkers program. Finally, Blinder emphasizes that Congress should deploy fiscal policy quickly after a recession starts, and wind it down only when the economy is well on its way to recovery.

The Challenge

Conventional thinking holds that monetary policy is typically better equipped than fiscal policy to stimulate the economy during a recession because it can be deployed quickly and with precision. A fiscal stimulus, by contrast, requires Congressional authorization and can take months to develop and debate before being enacted into law. Stimulus funding must then be distributed to approved projects and spent by the recipients, adding additional delays before it results in actual economic activity.

However, the severity of the Great Recession demonstrated that monetary policy alone might not always be enough. Despite lowering the federal funds rate—the overnight interest rate paid by banks—from roughly 5 percent to almost zero over the course of the recession, the economy remained tepid. Typically, a reduction in the federal funds rate lowers interest rates throughout the economy, encouraging businesses to invest and employ more workers and encouraging consumers to spend more, consequently lowering the unemployment rate. Though this did occur after the Great Recession, the recovery was unusually slow, and Federal Reserve officials had to resort to unconventional tools to further stimulate the economy and put it on to a path to recovery.

The Federal Reserve still faces limits to its principal tool for responding to recessions: as of May 2016 the federal funds rate sits below 0.5 percent. Should the economy weaken or slip into recession, the Federal Reserve would not be able to cut the funds rate much further to stimulate the economy. If monetary policy is of limited use during the next recession, alternative policies would be needed.

Fortunately, policy makers may also deploy fiscal policy to alleviate a recession. Fiscal stimulus, consisting of tax cuts or targeted increases in government spending, can be useful when there is considerable economic slack, or underutilized labor and capital resources. That discretionary fiscal policy can support an economy during a downturn has been known by economists since John Maynard Keynes's work in the 1930s; standard fiscal stimulus measures for combating recessions have been in policy makers' playbooks from about that same period. In addition, some scholars estimate that fiscal multipliers—measures of the increase in Gross Domestic Product (GDP) resulting from tax cuts or additional government spending—are larger when interest rates do not rise in response to stimulus. In fact, this was the case during the depths of the Great Recession from 2007 to 2009.

This insight, that fiscal stimulus is complemented by low and constant interest rates, points to a two-handed policy approach (fiscal and monetary) to economic downturns. In fact, coordinated fiscal and monetary policies reinforce one another. In earlier work, for example, Blinder and Mark Zandi (2015) estimated the impacts on real GDP of various antirecessionary policies implemented by the U.S. government starting in 2008. They found that in 2011 and 2012 fiscal and monetary actions were estimated to have raised real GDP about $2.1 trillion relative to a baseline without any stimulus. Of that large sum, the estimated impact of fiscal stimulus alone averaged $450 billion per year and the impact of the monetary/financial policies considered by Blinder averaged $900 billion per year. Since those contributions add up to only about two-thirds of the total, the rest—around $750 billion per year—was accounted for by positive interactions between the two sets of policies.

In short, Blinder argues, there are strong reasons for including a fiscal component in stabilization policy. Given that the efficacy of traditional monetary policy tools may be weaker in future recessions, that fiscal policy can substantially raise GDP when the economy is not operating at full capacity, and that coordinated fiscal and monetary policy can lead to increases in output above and beyond the contribution of either by itself, the question is not whether to attempt fiscal stimulus, but rather how to structure fiscal stimulus so that it results in the greatest returns.

Indeed, the United States made substantial use of both automatic and discretionary fiscal stimulus during and after the Great Recession. Automatic stimulus occurred in the form of programs like unemployment insurance (UI) and Supplemental Nutrition Assistance Program (SNAP, formerly known as food stamps) that expanded automatically with increasing need. Discretionary stimulus was accomplished largely through the American Recovery and Reinvestment Act of 2009 (ARRA, or the stimulus bill), which included tax cuts, aid to states, and infrastructure spending, among other measures. Establishing best practices for both types of fiscal stimulus is therefore of great practical importance.

A New Approach

According to Blinder, the basic idea behind using stabilization policy to combat recessions is disarmingly simple. There are times when aggregate demand (the economy's appetite for buying goods and services) falls short of aggregate supply (the economy's capacity to produce goods and services), thereby leaving resources underutilized and more workers unemployed. When that occurs, the government can bolster demand by (1) reducing taxes so that households and/or businesses spend more, or (2) spending more itself. Together, these policy levers are called "fiscal stimulus." Blinder considers options for improving the quality and extent of each, as well as (3) other policy tools and considerations that fall outside of fiscal stimulus but may still help the government to mitigate recessions.

1. Tax Policy

Tax cuts have historically been a popular way of using fiscal policy to give the economy a boost during a recession. However, not all tax cuts yield the same increase in output. As discussed in the "Spending Policy" section below, fiscal policy works best when it targets those who would like to borrow but cannot, and tax policy is no different. Unable to borrow money to maintain their consumption when their incomes fall, such households are more likely to spend the extra money they receive from tax cuts, increasing overall output. Recent work by Blinder and Mark Zandi (2015) shows that tax credits benefitting middle- and lower-income households, such as the Child Tax Credit and Earned Income Tax Credit, were among the most stimulative tax cuts during the Great Recession. Both credits were increased by the ARRA in 2009, and were estimated to increase total output in the economy above and beyond the size of the individual credits. (For estimates of the fiscal multiplier associated with several of the tax cuts implemented during the Great Recession, refer to table 1 of Blinder's Hamilton Project policy proposal.)

Blinder discusses some additional considerations for the design of effective countercyclical (i.e., recession-responsive) tax policy: (a) temporary income tax cuts, (b) value-added taxes and sales taxes, (c) temporary business tax cuts, and (d) formula flexibility.

a. Temporary Income Tax Cuts

While permanent tax cuts can certainly help to increase output, temporary income tax cuts are in some ways better tools for mitigating the effects of a downturn. Although temporary income tax cuts, in theory, should do little to increase spending—because farsighted individuals would not respond to a change that is merely temporary—in practice people spend much of the extra cash (perhaps due to borrowing constraints exacerbated by a recession). Blinder cites a number of studies finding that people are likely to quickly spend most of their tax rebates—in some cases, between 50 and 90 percent within three months of receipt.

b. Value-Added Taxes and Sales Taxes

Cuts to taxes other than income, such as sales, might have more-powerful fiscal multipliers because they better leverage the temporary status of the stimulus. Consumers anticipate the expiration of the value-added or sales tax cuts and make their purchases earlier rather than later, generating additional stimulus. Although there is no federal sales tax, 45 states rely on sales taxes for revenue. One vehicle for increasing demand might be for the federal government to temporarily compensate states for lost revenue in exchange for states lowering their sales taxes.

c. Temporary Business Tax Cuts

In the past, policy makers have suggested temporary tax cuts on businesses, such as the Investment Tax Credit and accelerated (bonus) depreciation to stimulate the economy. Both credits served the same purpose: to catalyze additional business investment by providing a credit for bringing investment decisions forward in time.

However, neither credit has proven particularly effective. In the case of the Investment Tax Credit, it was available for every dollar of investment—including spending the company was planning to make anyway—thereby diluting the impact on new, marginal investment. In the case of accelerated (bonus) depreciation, the credit was extended so often that it failed to incentivize businesses to shift investment across time, since businesses could reasonably expect future authorization. Thus, the experience of these business tax cuts points to two lessons learned: (1) credits to businesses should be authorized during recessions on a temporary basis, and (2) they should apply only to additional dollars spent beyond a pre-recession baseline level.

d. Formula Flexibility

Formula flexibility, or the writing into law of triggers for temporary tax cuts (as well as triggers for ending the cuts and returning tax rates to prerecession levels), would allow a faster fiscal response to a downturn by automating the deliberation of policy makers. Changes in a cyclical indicator such as the unemployment rate would both trigger cuts and terminate the cuts when the indicator returns to normal. Formula flexibility could also be implemented so that the cuts would be automatically introduced to Congress as a tax bill for an up-or-down vote without amendments. As Blinder points out, automatic, temporary cuts to income taxes would likely have sizeable and timely effects on consumer spending.

2. Spending Policy

On the spending side, Blinder identifies several spending policy areas that could be expanded or improved to help mitigate recessions: (a) targeted transfer programs, (b) countercyclical grants to state and local governments, (c) infrastructure spending, and (d) consumer-directed discretionary policy.

a. Targeted Transfer Programs

Targeting changes in taxes and transfer payments to the people most likely to spend the money quickly is one way to help mitigate recessions. This ensures that those who disproportionately suffer during recessions, such as low-income people and the newly unemployed, receive help. In addition, because these people have few other sources of income, they are likely to use most or all of their support, which helps to raise output in the economy. Earlier work by Blinder and Mark Zandi (2015), as well as by the Congressional Budget Office (2015), estimate large fiscal multipliers for transfer programs such as Supplemental Nutrition Assistance (SNAP) and unemployment insurance (UI). (See table 2 of Blinder's Hamilton Project policy proposal.)

Blinder notes that these programs could be significantly expanded. The Obama administration has proposed a reform of the UI extended benefits program under which the federal government would pay 100 percent of the cost of up to 52 additional weeks of benefits, in four 13-week tiers, for states experiencing rapid job losses or high unemployment. The reformed program would presumably replace the large discretionary component of federally funded unemployment benefits that Congress typically disburses during and after recessions, helping the government to more quickly dispense aid to the unemployed when a downturn hits.

In the same vein, Blinder suggests temporarily rebating part of the payroll tax to boost consumer spending. Since annual payroll tax receipts are more than $1 trillion, this could provide a substantial boost. In fact, payroll taxes are the largest tax paid by most Americans. Two considerations when rebating the payroll tax are (1) making sure that any rebate targets individuals who are most likely to spend it, for example by restricting the tax cut to the first $40,000 or $50,000 of earnings; and (2) ensuring that decreased flows to the Social Security Trust Fund—which already faces long-run deficits—are offset by other revenues.

b. Countercyclical Grants to State and Local Governments

Well-designed grants from the federal government to state and local governments can prevent state and local government spending cuts, which is just as important as spending more during a downturn. When a recession pulls down tax receipts, the federal government can, should, and normally does let its deficit rise—an important automatic stabilizer that mitigates economic contraction. But Blinder points out that few state and local governments have that luxury. Most are required to balance their budgets, which forces them to cut spending at just the wrong time.

If the federal government can use grants to state and local governments to mitigate or prevent such ill-timed fiscal contractions, it can reduce the severity of recessions. In fact, that was the main idea behind including so many such grants in the ARRA. Recent studies find that the ARRA grants to states such as those for highway grants and Medicaid had strong multiplier effects.

Federal spending on Medicaid is a good example of an existing grant to states to help them maintain spending levels during a downturn. In that particular case, cost-sharing formulas between the states and the federal government are adjusted periodically to account for differential income growth by state, but they are not explicitly cyclical. Blinder suggests that adding a permanent cyclical component to the calculations would be a good idea. Furthermore, if grants-in-aid are pre-legislated, then the extra money would start flowing automatically, helping to shorten the period between recession and policy response. Finally, grant programs should come with serious maintenance-of-effort strings attached to ensure that states spend the funds.

c. Infrastructure Spending

Increasing infrastructure spending during a downturn makes theoretical sense: excess labor and capital resources can be put to use on projects that ultimately raise productivity when completed. However, spending on infrastructure presents practical challenges. First, since most spending is done by state and local governments, which have budgeting sessions less frequently than the federal government and are likely to face major budgetary shortfalls during a recession, it could be difficult to incentivize new infrastructure spending. Therefore, Blinder proposes using programs such as the Obama administration's Build America Bonds, which from April 2009 through December 2010 offered a 35 percent subsidy on state and local governments' interest costs and included a termination date to incentivize spending in the short term.

Second, major infrastructure projects can take several years to implement, meaning that not all of the funding will get spent immediately. This undermines the effectiveness of infrastructure spending as a form of short-term stimulus. Although Blinder suspects that this is less of a problem during long downturns such as the Great Recession, shorter downturns place a premium on shovel-ready projects such as filling potholes. Such repair work can often wait for a recession and then be started and completed quickly.

Roadmap

- Before the next recession, Congress will adopt formula flexibility rules to make tax cuts automatic during a downturn.
- In the event of another downturn, Congress will pass a fiscal stimulus consisting of tax cuts and additional government spending designed along the following dimensions:
  - Income tax cuts, for individuals and businesses, will be explicitly temporary.
  - Business tax cuts will apply only to every additional dollar spent on investment.
  - States will cut sales taxes, and the federal government will reimburse them for lost revenue.
  - Payroll taxes will be partially rebated to workers.
  - Automatic stabilizers, including SNAP and UI, will be expanded.
  - Federal Medicaid grants will be adjusted to follow the business cycle.
  - Federal grants for other spending by states will be established.
  - Infrastructure spending will focus on shovel-ready maintenance projects.
  - Build America Bonds (or a similar program) will be reinstated for states.
  - Funding will be appropriated to reimburse consumers for purchases of large durable goods (e.g., cars, home appliances, computers, etc.).
  - Federal credit programs, particularly those for housing, will be expanded.
- Congress will legislate rules to prevent stimulus from being terminated prematurely.

d. Consumer-directed Discretionary Policy

Temporary subsidies for expensive durable goods, which consumers would otherwise try to avoid purchasing during a recession, can increase consumer spending. Blinder cites the Car Allowance Rebate System, better known as the Cash for Clunkers program, as an exemplar of this policy. The temporary subsidy provided to owners of old, inefficient cars to encourage them to upgrade to new, more-efficient models was available for 55 days in the summer of 2009. The program successfully increased purchases of new cars and had to be increased from an initial $1 billion to $3 billion total to meet demand.

Blinder cites two reasons for the success of the program. First, Cash for Clunkers was temporary; instead of waiting to purchase a new car later when the economy had bounced back, consumers were incentivized to bring their consumption forward in time to take advantage of the subsidy.

Learn More about This Proposal

This policy brief is based on The Hamilton Project discussion paper, "Fiscal Policy Reconsidered," which was authored by

ALAN S. BLINDER
Princeton University

Second, the private sector widely advertised the availability of the subsidy, which likely increased sales. Other products that could receive this type of subsidy include expensive durable goods (e.g., home appliances, computers, or smart phones) or, on the tax side, credits for first-time homebuyers. Such programs should also be somewhat longer-lived to sufficiently tap into consumer demand for new products and stimulate additional production.

3. Other Policy Tools and Considerations

a. Length of Stimulus

An important lesson from the most recent economic recovery is that fiscal policy should not prematurely swing from stimulus back to austerity. One possible rule of thumb might be to withdraw stimulus only once the unemployment rate falls to within 1 percentage point of full employment and continues to decline. Other cyclical indicators could be used as well, but the basic idea is that policy makers should defer deficit reduction until a self-sustaining expansion is well under way.

b. Avoiding Policy Lags

Several steps occur between the first recognition that the economy has entered recession and the actual implementation of fiscal stimulus. Although this policy lag cannot be eliminated outright, automatic stabilizers could be expanded to give the economy an initial boost while a discretionary stimulus package is assembled by policy makers.

c. Federal Credit Programs

Blinder also calls attention to the countercyclical role of federal credit programs, which subsidize various sorts of borrowing. While these programs range over a wide variety of activities, housing disbursements delivered through the Federal Housing Agency, Fannie Mae, and Freddie Mac are the largest by far. Recent research finds that credit provided through these programs rivaled the stimulative impact of the ARRA.

Importantly, most of the increased disbursements came automatically. Congress did not pass major new laws, with the exception of some changes to Federal Housing Agency programs. Rather, when private-sector mortgage finance receded, federally backed lending rose to fill the huge gap. The idea of using federal credit programs—whether automatic or discretionary—as a countercyclical tools merits further consideration.

Costs and Benefits

Economists have long recognized that at least three factors could undermine the benefits of pursuing fiscal stimulus.

1. Raising the government budget deficit to provide fiscal stimulus could push interest rates up, and those higher rates will reduce, or crowd out, some interest-sensitive private spending—unless monetary policy prevents this from happening.
2. Once the government accumulates a lot of debt, its capacity to borrow even more could be limited. Alternatively, policies that lead to larger future deficits can be contractionary in the short term if they raise long-term interest rates.
3. Hyperrational, farsighted consumers could perceive tax cuts as merely shifting their tax burdens over time. In other words, they suspect that lower taxes today will be balanced by higher taxes tomorrow. If that is the case, they will perceive no increase in long-run spendable income and hence have no reason to spend more.

Under the right circumstances any one of these three factors could reduce the benefits of fiscal stimulus in theory. However, in practice these concerns are likely overstated:

1. Although crowd-out might be severe in a strong economy with firms and households competing avidly for funds, fiscal stimulus is normally prescribed when economies are weak and substantial slack exists. Under such conditions, the Federal Reserve would probably act to prevent interest rates from rising in response to fiscal stimulus.
2. Borrowing capacity has never been an issue for the U.S. government, whose debt securities are among the safest in the world. Even today, with the debt-to-GDP ratio higher than it has been for decades, Treasury borrowing rates are extremely low. However, the ability to borrow more is often a relevant constraint on fiscal policy for other countries.
3. Ordinary people do not behave like the super-rational calculating machines envisioned by economic theory. As Blinder discusses, the evidence says that consumers react to tax cuts by spending more, even when the tax cuts are temporary.

Conclusion

There is a strong rationale for deploying fiscal policy to counteract downturns in the economy. Blinder proposes improving the quality of tax cuts and targeted spending to maximize their impact during and after a recession. On the tax side, this means temporarily cutting taxes (preferably for those individuals and families most in need of funds), investigating federal reimbursements for states that cut their sales taxes, and establishing formula flexibility to increase the speed at which cuts are made. On the spending side, Blinder calls for spending more on transfer programs when the economy is weak, making greater use of countercyclical grants to states to prevent spending cuts, increasing spending on short-term infrastructure projects and making it easier for states to raise money for infrastructure projects, and subsidizing spending on large durables such as cars. He also emphasizes the importance of maintaining stimulus until the economy is on a path to recovery, reducing the time between the onset of a recession and the fiscal policy response, and investigating greater use of federal credit programs.

Questions and Concerns

1. It has been argued that government spending could actually be "job-killing." Is this likely?

No. During the debate around the stimulus package contained in the American Recovery and Reinvestment Act (ARRA) in 2009, some politicians characterized the fiscal stimulus package as "job-killing government spending." However, raising federal purchases means either that the government hires workers and puts them directly on its own payroll or that it buys more goods and services from private businesses, which in turn increases their payrolls. Critics might legitimately object to any particular spending program as excessive, misguided, inefficient, and so on. But how more spending might kill jobs is unclear. Furthermore, with so much slack in the economy, fiscal multipliers were probably unusually large at the time of ARRA's passage, and certainly not negative.

2. Can unemployment insurance reduce employment?

There is a well-known downside to providing more-generous unemployment insurance (UI) benefits: the disincentive effects on job seeking and job acceptance. That is, for example, why unemployment benefits are kept well below 100 percent of previously-earned wages. The optimal level of UI benefits balances such disincentive effects against the benefits of supporting aggregate demand when the economy is weak. Notice, importantly, that this balance shifts in the direction of higher UI benefits when the economy slumps and jobs are harder to find.

3. Other than UI and Medicaid grants-to-states, what other spending programs are good candidates for automatic stabilization?

The Supplemental Nutrition Assistance Program (SNAP, formerly known as food stamps) might be one excellent choice. There is a lot of money in SNAP (about $74 billion in FY2015), and incremental funds are likely to be spent quickly by families who are, quite literally, living hand-to-mouth. A recent study found that an astonishing 97 percent of SNAP benefits are spent within a month, making the program a good candidate for expansion when stimulus is needed.

Highlights

The lengthy struggle to emerge from the Great Recession has led to a serious rethinking of a previous verdict: that the job of stabilization policy in a downturn could and should be left exclusively to monetary policy. As a result, a new recognition of the importance of fiscal policy to mitigate recessions has emerged. In a new Hamilton Project policy proposal Alan S. Blinder of Princeton University reassesses the role of fiscal policy and proposes a series of reforms and best practices to guide the use of fiscal policy during the next recession.

The Proposal

Target tax cuts. On the tax side, Congress would: make income and business tax cuts temporary; encourage states to implement temporary sales tax cuts (with revenue losses reimbursed by the federal government); and make tax cuts automatic to reduce the lag time between recessions and stimulus.

Target government spending. On the spending side, Congress would: expand automatic stabilizers such as the Supplemental Nutrition Assistance Program (SNAP) and unemployment insurance; administer grants to states and municipalities; and increase infrastructure spending—with a focus on shovel-ready projects. Congress would also establish bond programs similar to Build America Bonds to make it easier for states to finance new developments. Additionally, Congress would deploy consumer-directed discretionary programs similar to the Car Allowance Rebate System, known as Cash for Clunkers, for large durable goods such as cars, home appliances, and computers.

Benefits

Underutilized labor and capital resources, which constitute the slack in a weak economy, stand to benefit the most from these proposals. Targeted spending will create new opportunities for workers and businesses. Tax cuts will benefit individuals and businesses and encourage additional consumption and investment following the downturn. Expanded automatic stabilizers will help the newly unemployed and provide support to those households struggling to make ends meet. Stimulus spending will help states balance their budgets without resorting to massive cuts in services. Importantly, the benefits of the stimulus will be greater when implemented closer to the onset of the downturn, and the stimulus will yield the greatest boost to output if allowed to extend until the economy is well on its way to recovery.

THE HAMILTON PROJECT

1775 Massachusetts Ave., NW
Washington, DC 20036

(202) 797-6484

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