JOINT ECONOMIC COMMITTEE

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FISCAL POLICY STIMULUS: TIMELY, TARGETED, AND TEMPORARY?

Proposed measures to use government fiscal policy to boost economic activity, under the label of "stimulus," involve large sums. While proposals being considered in the House and the Senate differ slightly in magnitudes and details, the overall size of packages currently under debate is around $825 billion, with a mixture of government spending and tax reductions. How large of an effect on economic activity, measured by possible changes in the gross domestic product (GDP) can we expect? Unfortunately, there is no consensus among economists on what might be the sizes of those effects. However, there is a serious possibility that the currently proposed stimulus will fail to effectively stabilize the U.S. economy and will instead retard growth over the long term.

WHAT HAPPENED TO THE MANTRA "TIMELY, TARGETED, AND TEMPORARY?"

Ideally, fiscal policymakers could recognize the onset of a recession with pinpoint accuracy and could respond with laser precision by immediately enacting deficit-financed measures that would provide the largest possible boost to aggregate demand (consumer spending, business spending, government spending, and the net of exports over imports) per dollar of additional deficit. Then, in the ideal world, the fiscal stimulus would be turned off immediately after the recession threat passes, and the short-run deficit boost that was used to finance the temporary stimulus would be paid off in short order. Unfortunately, we do not live in such an ideal world. Rather, there are substantial lags and uncertainties associated with fiscal stimulus measures. As a result, significant portions of the proposed stimulus are not timely or temporary and may not be properly targeted.

TIMELY:

There are three lags associated with stimulus actions. Those are: a *recognition lag*—the time between when recessionary forces take hold and when policymakers actually recognize the slowdown; an *implementation lag*—the time between recognition of possible utility of fiscal stimulus and actually piecing a stimulus package together through the legislative process; and an *impact lag*—the time between enactment of stimulus package measures and actual effects on the economy in the form of things like increased spending, output growth, and job growth.

Currently, the recognition lag is not relevant, as everyone recognizes that the economy is in a recession that could prove deep and protracted. We are currently in the implementation stage of deciding whether to use stimulus measures and, if so, what types. The impact lag remains to be seen if stimulus measures are adopted.

According to Fed Chairman Bernanke, in testimony before the House Committee on the Budget on January 17 of last year: "To be useful, a fiscal stimulus package should be implemented quickly and structured so that its effects on aggregate spending are felt as much as possible within the next twelve months or so. Stimulus that comes too late will not help support economic activity in the near term, and it could be actively destabilizing if it comes at a time when growth is already improving. Thus, fiscal measures that involve long lead times or result in additional economic activity only over a protracted period, whatever their intrinsic merits might be, will not provide stimulus when it is most needed."

Lengthy spend out horizons associated with many "infrastructure" and other long-term investment projects, as recognized in analyses of the House and Senate stimulus measures by the Congressional Budget Office, are of particular concern. Infrastructure spending is likely not to be a very effective way to stimulate the economy in the near term. Even if there are "projects on the shelf" that can be started the day after legislation is enacted, spend-outs on infrastructure projects often take many years. Thus, it is not very effective, in terms of immediate bang for the buck, to spend on infrastructure projects. Indeed, according to a January 2008 CBO report:

> "Practically speaking, however, public works [a.k.a. infrastructure] 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."
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> "Some of the candidates for public works, such as 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 not 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."

Currently proposed stimulus packages contain many spending projects that involve parts of long-term government investment or reform agendas. According to one analysis by the CBO, only 60% of the total $825 billion in spending contained in the stimulus package passed by the House would occur by the end of FY 2010. Pouring an additional $330 billion into an already recovering economy after 2010 could be, as Mr. Bernanke put it, "destabilizing." As such, long-term projects should be kept out of a package intended to stimulate economic activity. While there may be long-term merits to the projects that involve infrastructure, energy policy, health care policy, education policy, environmental policy, and unemployment insurance reform, long-term spending in these areas does not pass the "timely" or the "temporary" tests.

TARGETED:

To maximize the efficiency of future taxpayers' dollars spent on fiscal stimulus, only measures that provide the greatest "bang for the buck," or increase in output per dollar of spending or tax cut, should be pursued.

The basic Keynesian idea behind fiscal stimulus is to get funds in the hands of those most likely to spend now, to put business incentives in place that are most likely to stimulate investment spending now, and to provide government transfers to states that will lead to greater state spending now (and not simple budget shuffling with spending unchanged). That means, get funds to households who will spend it, provide investment incentives to firms that will respond with increased investment, and possibly provide funds to state programs most likely to generate immediate spending increases.

Stimulus packages currently under consideration in the House and Senate devote substantial sums to long-term spending programs that are not likely to target spending on the near-term economic weakness or, necessarily, on those households, businesses, and government entities most likely to quickly spend (i.e., those with high "marginal propensities" to spend).

TEMPORARY:

Because fiscal stimulus measures increase government spending or reduce taxes, such policies raise budget deficits in the short term. That effect is desirable if short-term stimulus is deemed to be necessary and if the measures lead to temporary increases in aggregate demand that would otherwise not have occurred in a weakening economy. However, higher deficits can lead to higher interest rates and slower economic growth in the long run if they are allowed to persist. The longer deficit-financed fiscal stimulus measures are in place, the greater the addition to the already unsustainable long-term fiscal course given existing entitlement promises.

In addition to concern about interest-rate effects of higher deficits and government debt, there is a concern about whether stimulus packages currently under debate are, in fact, stimulus measures or a mixture of some stimulus with a lot of long-term spending. Much of the spending measures in current "stimulus" proposals are, under the guise of stimulus, actually long-term investment projects. Whatever the merit of those projects, they should be judged in a longer-term appropriations process in which each project is weighed on the basis of expected future rate of return compared to expected costs. While there is much to be said about the costs and benefits of long-term issues surrounding health care, the environment, energy, and education, the appropriate venue for vetting long-term investment projects to make progress in these areas is not in a hasty process of rushing to enact stimulus measures.

If the long-term investments in things like education, "green energy," and the like that have been tucked into existing stimulus packages are implemented, what mechanisms would government have to turn those spending projects off or ramp down their scale should economic recovery occur relatively soon? Absent such mechanisms, a concern is that the stimulus packages currently under consideration will end up implementing a permanent expansion of government spending and a permanently larger size of government in our economy.