Brief Presentation of "If, When, How: A Primer on Fiscal Stimulus"
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Thank you, Bob, and again thanks to all of you for joining us this morning.

The paper that Jason and I have written has a straightforward message:

Fiscal stimulus can be a useful complement to monetary stimulus if—but only if—it is timely, targeted, and temporary.

These criteria are not original with us, and they are not controversial among analysts who have studied the effects of past changes in fiscal policy. Economists know what works and what doesn't. Therefore, criteria are extremely important if we want fiscal stimulus to provide an effective boost to the economy this year, rather than having little effect or perhaps even being counterproductive. So, the challenge for everyone involved in the policy process is to be resolute in sticking with these principles as alternative proposals for fiscal stimulus are designed and debated in coming months.

Our paper is not long, but we cover a number of points and present a range of evidence, and I won't try to summarize all of that for you now. In any case, I'm sure that you will all take the paper home, download it from the Brookings web site, study it carefully, send copies to your friends and families, and so on. So let me use my few minutes here to flesh out these three criteria for effective fiscal stimulus.

First is the notion of timely stimulus:

Making stimulus timely is crucial because the average recession does not last very long and because providing a stimulus to economic activity when the economy is already humming along again would end up increasing inflation or inducing the Federal Reserve to run tighter monetary policy in order to avoid inflation. Either way, delayed stimulus does nothing to support economic activity when that support is needed.

But making stimulus timely is as difficult as it is crucial. It's difficult in part because forecasting economic conditions is so hard. It's also difficult because the political process of deciding what to do takes time, the implementation of changes in fiscal policy takes time, and sometimes the impact of fiscal changes on household and business decisions takes time as well.

Therefore, to be effective, fiscal stimulus needs to be enacted quickly after the need for stimulus is recognized, and it needs to involve policy changes that can be administered quickly and that get money circulating in the economy quickly.

The second characteristic of effective stimulus is the idea of targeted stimulus:

We use the word “targeted” in two senses. Stimulus is targeted in a macroeconomic sense if each dollar of lower taxes or higher government spending induces the maximum change in total spending and GDP. Stimulus is targeted in a fairness sense if the lower taxes or higher spending provide the largest benefits to families who will be most affected by an economic downturn.

Fortunately, this is one of the rare cases in economics where two goals can be satisfied at the same time, rather than being at cross purposes with each other and posing an unpleasant tradeoff. Consider families further down the economic ladder—people who are living closer to the economic edge. These families are likely to be hurt the most by a slowing economy. They are also the ones who will spend the largest share of any extra income they receive. Therefore, fiscal changes targeted toward them will have the largest bang-for-the-buck in terms of both fairness and macroeconomic impact.

This conclusion is a matter of both logic and evidence. I’ve just summarized the logic for you, and the paper reviews some of the evidence that economists have derived from past changes in taxes and other components of fiscal policy.

The third element of effective stimulus is the notion of temporary stimulus:

As everyone knows, the federal budget is slightly out of balance now and terribly out of balance over the next decade and beyond. We cannot afford to make the long-run budget outlook worse.

But we don’t need to make it worse in order to generate effective fiscal stimulus. Indeed, permanent policy changes that make the long-run budget outlook worse would generally have less stimulative effect than well-chosen temporary policy changes.

The logic again is simple: Temporary tax cuts or spending increases targeted at households who will spend a good share of the money they receive can provide a strong boost to total spending just when the economy needs it most. Permanent tax cuts or spending increases may also encourage more household spending if targeted correctly, but the expectation of higher future budget deficits tends to push up interest rates today and thereby offset some of the direct stimulus.

The paper discusses this logic at greater length and again presents the relevant evidence.

The question then becomes: What do these principles—that policy be timely, targeted, and temporary—imply about specific types of fiscal stimulus that have been discussed?

One type of effective stimulus is to expand programs that help people in economic difficulty, such as unemployment insurance and food stamps.

On the government’s ledgers, these policies would show up as higher spending, although economists would view these increases in transfer payments as more analogous to a cut in taxes, because the goal is to get money into the hands of households. Regardless of the label, expanding these programs would be effective stimulus because the changes can be implemented quickly, they are correctly targeted to achieve the maximum bang-for-the-buck, and they can

easily be done for a limited period. However, such expansions would probably be fairly small in dollar terms compared with the size of our economy.

In terms of policies that can be conducted on a larger scale, the most effective stimulus would likely come from personal income tax credits that are a flat amount per household and are refundable to households who do not have positive tax liability.

Such flat, refundable tax credits would be effective stimulus, because the credits can be implemented quickly, most of the money would flow to households who would spend a large share of what they receive, and the credits could be done on a one-time basis that would provide stimulus when we need it without worsening the long-run fiscal situation.

The paper expresses more doubts about the utility of increases in infrastructure investment or temporary investment tax incentives.

It is difficult to design infrastructure investments that could take effect as quickly as the stimulus might be needed. And the experience with the so-called "bonus depreciation" for businesses several years ago is that it provided only a small amount of stimulus at best.

The policies that would be least effective at providing stimulus, and might even be counterproductive in a stimulus sense, would be across-the-board tax cuts or an extension of the 2001 and 2003 tax cuts.

Whatever the merits or demerits of these policies in terms of long-run efficiency, equity, and budget balance, they simply would not provide much, if any, short-term boost to economic activity. In particular, making the 2001 and 2003 tax cuts permanent would hardly provide a timely boost because it would take effect in 2011; it would not be targeted at households who would spend much of the money; and the permanence could raise interest rates and crowd out some investment today.

In closing …

I want to emphasize that most economists are skeptical about countercyclical fiscal policy not because fiscal stimulus that is timely, targeted, and temporary is a bad idea, but because history suggests that these three criteria are often not satisfied. It is up to all of us engaged in the policy process today to add a better example to the history books.

Thank you very much.