

Using Fiscal Policy to Fight the Next Recession

Testimony to the House Budget Committee on October 16, 2019

Douglas W. Elmendorf

Dean and Don K. Price Professor of Public Policy, Harvard Kennedy School

Thank you, Chairman Yarmuth, Ranking Member Womack, and Members of the Committee. I am delighted to be back here, where I spent so many good hours when I was director of the Congressional Budget Office. Of course, today I am not speaking for CBO, or for my current employer, but only for myself.

I do not think a recession is imminent in the U.S. economy. But clearly the economy has slowed a great deal over the past year, and economic forecasters surveyed by the *Wall Street Journal* now see the probability of a recession over the next 12 months at about one-third, up from less than one-fifth a year ago. Unfortunately, predicting recessions is quite difficult, and we should not count on economists to correctly anticipate the timing of the next one. However, we know that there will be a next one, and we should be ready for it. So, I commend the Committee for convening this hearing.

I want to make three points about using fiscal policy to fight the next recession.

First, vigorous use of countercyclical tax and spending policies will be crucially important for limiting the severity of the next recession.

When the economy goes into recession, the Federal Reserve will presumably cut the federal funds rate to near zero, as it did in the last recession. However, because market interest rates are so low already, the Fed will have less room to cut than it had in previous recessions. The Fed will try to compensate through quantitative easing and forward guidance. On balance, though, I expect that the Federal Reserve will be able to provide less monetary stimulus than in past downturns.

That will leave more for fiscal policy to do. Suppose that, when the economy next goes into recession, Congress and the president agree on a collection of government spending increases and tax cuts twice as large as the 2009 Recovery Act. Such fiscal stimulus would make the recession less deep and less lengthy than it would otherwise be. Fewer people would lose their jobs, and people who did lose jobs would find new jobs more quickly. Fewer families would be evicted from their homes or be unable to pay their medical bills.

My second point is that, notwithstanding the historically large amount of federal debt outstanding, the government has plenty of budget capacity to use fiscal stimulus vigorously.

The legislation I just described would have a direct budgetary impact of about \$1.7 trillion. Based on a large amount of economic research over the past decade, a reasonable estimate is that—with the federal funds rate near zero—this legislation would increase GDP over the following few years by roughly 1½ times as much.¹ Higher GDP means higher taxable incomes, so the federal government would recoup some of the direct cost, leaving a net budgetary cost of about \$1.1 trillion.²

That figure is very large by almost any standard, but it represents only about one year's worth of federal borrowing at our current pace. There is little reason to think that financial-market participants would find this fundamentally different from the path we are already on today. Nor would holding off debt by a year be worth the lost national output and additional human suffering of a deeper or longer recession.

Indeed, the Tax Cuts and Jobs Act of 2017 is generating a larger budgetary cost and a smaller increase in national income than the future stimulus I have described.³ If your goal is to raise national income at a low budgetary cost, fiscal stimulus in a recession would be more effective than the tax law. Moreover, the income gains from fiscal stimulus would be more widely shared than the income gains from the tax law, a consideration that should be central to your thinking.

To be clear, federal debt cannot increase indefinitely relative to the size of the economy, and you or your successors ultimately will raise taxes and cut benefits and services. But market interest rates on federal debt are now at historically low levels and have been trending down for decades. Federal borrowing is thus less costly, creates less risk, and does less harm to the economy in the long run than most economists have expected. Therefore, the urgency of putting federal debt on a sustainable path is greatly reduced.⁴

¹ For summaries of this body of research, see Valerie Ramey, “Ten Years after the Financial Crisis: What Have We Learned from the Renaissance in Fiscal Research?,” *Journal of Economic Perspectives*, 2019; Gabriel Chodorow-Reich, “Geographic Cross-Sectional Fiscal Spending Multipliers: What Have We Learned?,” *American Economic Journal: Economic Policy*, 2019; and Congressional Budget Office, *How CBO Analyzes the Effects of Changes in Federal Fiscal Policies on the Economy*, 2014.

² For further discussion, see my op-ed in the *Washington Post* in September 2019, “Yes, We Still Have the Fiscal Capacity to Deal with a Recession,” which is also available on my Harvard Kennedy School web page.

³ See Congressional Budget Office, “The Effects of the 2017 Tax Act on CBO’s Economic and Budget Projections,” Appendix B in the *Budget and Economic Outlook, 2018 to 2028*.

⁴ For further discussion, see my remarks at Brookings in April 2019, “Should We Reduce Federal Budget Deficits Now?,” which are available on my Harvard Kennedy School web page. For analysis underlying those remarks, see my paper with Louise Sheiner, “Federal Budget Policy with an Aging Population and Persistently Low Interest Rates,” published in the *Journal of Economic Perspectives* in July 2017 and available in working paper form on the Brookings web page.

My third point is that effective fiscal stimulus requires that spending increases and tax cuts be targeted appropriately.

Effective stimulus requires that government spending increases occur quickly, which is easier for certain payments to people and state governments than for projects to build new infrastructure. Effective stimulus also requires that tax cuts be spent quickly by the recipients, which is much more likely for cuts aimed at lower- and middle-income households than higher-income households. Moreover, both spending increases and tax cuts would have larger and more beneficial effects if they were focused on parts of the country that have especially high unemployment.⁵

In addition, because recessions are difficult to predict and the legislative process often works slowly, it would be valuable to build more anti-recessionary policy into law today, with a trigger for activation. For example, the law could say that, if the unemployment rate rises by $\frac{1}{2}$ percentage point or more over a six-month period—as it has in previous recessions—then payroll taxes will be cut and Medicaid payments to states increased until the unemployment rate declines significantly.

In sum, the federal government can and should undertake vigorous fiscal stimulus to counteract the next recession, and such stimulus can and should be built into law before the recession arrives. Thank you.

⁵ For further discussion, see my forthcoming paper with Karen Dynan, “National Fiscal Policies to Reduce Cyclical Volatility in U.S. States.”