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The Impact of a Fiscal Stimulus Program

Adam S. Posen argues that if the Obama team structures its stimulus package properly, it can have a significant effect on the economy.

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Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman at the Peterson Institute for International Economics. Our guest today is Adam Posen, deputy director of the Peterson Institute. We're going to talk about the future of economic stimulus. Thanks for coming, Adam.

Adam S. Posen: Thanks for having me.

Steve Weisman: The incoming Obama administration is assembling a large economic stimulus plan, which I gather they're calling an economic recovery plan. The word "stimulus" is too hard for people to get their heads around. What's your sense of what is shaping up for presentation to Congress in the New Year?

Adam S. Posen: Clearly, Steve, the Obama team feels there's going to be a huge shortfall of aggregate demand. And it's much larger than many expected. And the way you make up for that, especially when interest rates are already at zero, is you cut taxes or you increase government spending. Therefore, the part of your economy that's not constrained by credit defaults, or whatever, is the one that provides impetus to actually purchase the stuff.

So the Obama team has said they essentially want to offset the degree to which there's an output gap, that is to say, how much the economy is growing below potential, and therefore, how much slack there's likely to be, which leads to unemployment in the economy. That is on the order of at least 2 percent, probably 3 percent of GDP in this year and heading into another 3 percent of GDP next year if we assume the economy grows at 2 to 2.5 percent steadily per year. So that translates into the kinds of numbers you're hearing or even something bigger. The kind of number they're talking about is roughly $400 billion a year, a little short of 3 percent of GDP a year for two years.

Steve Weisman: What should be the composition of that package?

Adam S. Posen: It's definitely made up of different elements. You always want to design your stimulus, to the degree you can design it, with an eye to several things at once. First, if you're going to spend money and your concern is the shortfall in the economy, you want to maximize what's called the multiplier, meaning how much overall growth you have in the economy for a given dollar spent. You can do things like cut taxes. But usually, as we saw six months ago, when people are feeling scared, if you give them a tax cut, they save most of it .Therefore, the multiplier's pretty low, say 0.3. If you do things, which they're proposing to do, like give state governments money directly, and those people don't furlough teachers and policemen and construction workers who otherwise would have been laid off immediately, the multiplier's very high because then you actually replace their salaries, and those people continue to spend. Then there are knock-on effects and so you talk about a multiplier well above one.

So the package that they're talking about now is going to heavily emphasize direct aid to state and local governments, direct aid to what's called Medicaid, which is the state-level insurance program, but which people don't always realize is jointly funded by the federal government and state governments. They will have shortfalls unless the federal government makes it up.

And then the thing that's getting the most attention: what's called the infrastructure spending. Now, infrastructure spending is the attempt to do two things at once. First, maximize the multiplier, as we just said, but also to spend money on things that have lasting value, that will have benefits in the future. Think about for you personally, right? If you spend money, you can spend it on a bunch of Domino's Pizzas or you can spend it on a great book. Presumably, the great book helps you in the future be more valuable or at least more impressive than the Domino's Pizza would have. And so similarly, we've got the US government right now spending on infrastructure—things like roads, communications, preventing breakdowns in sewers, alleviating congestion at airports and various places—that ideally not only have the direct benefit right now but actually make things more efficient in the future.

Steve Weisman: But on infrastructure spending, isn't one of the problems that the spending gets spread out over a longer period of time and doesn't really have the short-term impact that the economy needs?

Adam S. Posen: That's a very real concern with infrastructure projects—I mean, think about in your local economy, right? I grew up in Boston and there was this thing called the Big Dig, which was the largest public works project anybody's seen until now. And the idea was, they were going to put this highway underground that had been a blight upon the city. Well, it took them 12 years and billions of dollars because you can't do that overnight. If you extend the subway, it takes several years to construct.

Steve Weisman: So do you think that there are enough infrastructure projects on which the money can be spent quickly?

Adam S. Posen: Well, the flipside of this is, we look at, as many people have noted, that terrible bridge accident we had in Minneapolis the other year, and when they decided they were going to do it, it took less than 18 months start to finish to replace that bridge. So it's a question of being judicious in what particular projects you pick, and the governors of the various states have come together and put together a list on which they claim they've got $130 billion, plus or minus, worth of infrastructure projects that literally are turnkey, that if the federal government gives them the money today, they will be ready to start construction tomorrow, next week, next month.

Steve Weisman: If we have a package of this size, what do you think the impact on the economy can be?

Adam S. Posen: I'm on record, and I'll be on record here in saying yes, I think it can really work. The historical record is that when fiscal policy has been tried on a large scale and well designed it does work. In the 30s, there was a lot of stuff done by the New Deal that wasn't well designed from a multiplier perspective or, in fact, was offset by tax increases, because people worried about a balanced budget.

The same thing happened with Japan in the 1990s where people think they wasted a lot of money. They did waste a lot of money. But the reason it didn't stimulate the economy was, as research I've done shows, they either didn't spend anywhere near as much as they said they were going to spend or they raised taxes at the same time they were increasing spending. So out of net, it wasn't much.

Looking at the data, looking across countries, whenever there's genuine fiscal policy in the sense of fiscal stimulus—you spend without raising taxes at the same time, and you do something that is not entirely stupid with it like build bridges to nowhere—you get a big result. So the issue isn't so much that in the short term, it won't work. I'm actually pretty confident it will. The issue is: What are the long-term costs? What are the trade-offs further down the road?

Steve Weisman: Let me ask about that. You mentioned the Big Dig. A lot of people feel this package is digging us into a bigger hole fiscally over the long term, and that that in turn makes people less confident about the future. What do you think of that argument?

Adam S. Posen: I think it's a fair argument as far as it goes. We do have a lot of debt. More importantly, we're about to issue a lot more debt. So there's the fact that we're going to, on this plan, have government deficits on the order of 9 percent of GDP, which is very large, especially for peace time. You can't really call this peace time but for non-major war.

And there is an issue of where we're going to get the money for that. Some of it has to come from abroad, probably, or else Americans have to save a lot more, in which case that sort of offsets some of the spending. But I think we shouldn't get too carried away with this. You can argue that it's not in the long-term interest of the United States to keep running deficits of that size, or anywhere close year after year. I'm content to do that, but the argument that people are so scared of government budget deficits that it will meaningfully offset this is sort of nonsense.

Think about it this way: Everyone knows Social Security's supposed to be bankrupt. OK, it's not true. But anyway, everyone believes that. I see opinion poll after opinion poll: "You're 20 years old. What do you think Social Security will be when you retire?"

"It isn't going to be there. I don't worry about that."

And then you ask the person, "How much are you saving this year?"

"Saving? What saving?"

I mean, this is not the way actual people behave. It's nice in theory but it's not true in practice.

Steve Weisman: Do you see aid for homeowners through refinancing their mortgages as a piece of economic stimulus? Is that a good idea?

Adam S. Posen: Yes, it's a piece of economic stimulus. No, it's not a great idea.

Steve Weisman: Because?

Adam S. Posen: It's definitely stimulus in that if you have people who are indebted and they suddenly feel, "Oh, wow, the debt is less oppressive," they're going to save less and spend more and they'll be less fearful. It's not a great idea because it's not clear to me that it provides the biggest multiplier. And it's not clear to me that it provides the biggest infrastructure benefit, because when you think about it, we have an economy in which we've arguably invested too much in housing for the last few years, in which we already have a tax code biased toward housing, and we're coming off a bump in housing. So maybe the point is: We shouldn't be spending as much on housing as we were. So on two counts to me, it's not the best use of money. It's very politically popular. Some people argue it would have a huge multiplier effect. I'm more skeptical, but OK.

But there's a third piece of it that bugs me about the mortgage bailout, in which it may be right but we still have to think about it. It's fundamentally regressive, all right? I mean, if you think about it, leave aside the question of the other deserving people who fell into trouble and undeserving people who borrowed too much on their houses. Forget all that. Just remember that basically the elderly and the poorest in society are the only ones who don't own homes, right? It's the middle class and upper-middle class and the middle-age group and late-middle age who do own homes. So essentially what we're saying is: We're going to give the biggest tax break to the group of people who are least likely to lose their jobs. I'm not sure that's entirely fair right now.

Steve Weisman: A final question, Adam. Will the stimulus work if other countries don't do their fair share in also stimulating their economies? There's a lot of talk that Europe, for example, is falling short in spite of vague commitments at the G-20 in November.

Adam S. Posen: Yeah, this is a very real issue. But it's more an issue for other countries than for the United States. Paul Krugman has written about this recently, criticizing Germany in particular, which of the major economies is in the best position beside China to stimulate and is choosing largely not to do so. I tend to agree with Paul. The issue is what's called leakage. If you're a country that's an open economy and you spend money on fiscal expansion, some of that money will be spent abroad, right? Because you spend money just the way you normally would and some of it's spent on bananas and some of it's spent on foreign cars and the stimulus goes abroad. For countries that are very open, that leakage can be very large, and the United States is reasonably open. We have a pretty high tendency to import but in point of fact as a share of the economy, imports aren't that big. So we only get, say, 20 percent leakage at the most. In the countries in Europe, which are much more international, much more globalized, the leakage can be enormous.

The second piece of it that's a problem is, as you were talking earlier, Steve, about people getting scared when the government spends too much. In some countries, which start out with much higher debt levels than the United States, and have much less of a history of fiscal probity, that is a much more realistic concern. People will take their money out of the country. Interest rates will rise and the country's seen as being undisciplined with their fiscal policy. So when you have Germany or some other country saying, "Yeah, we want to be disciplined" and making their neighbors look bad, that also diminishes the effectiveness of the fiscal policy of their neighbors. Because then everyone says, "Oh, yeah, they really are undisciplined. This country (say the United Kingdom or say South Korea) is really spending rather than saving and I could put my money into a comparable country that is much more disciplined." So those are two ways in which fiscal stimulus abroad should match that at home. The United States has fewer worries about that than most countries though.

Steve Weisman: Adam Posen, thank you very much for joining us on Peterson Perspectives.

Adam S. Posen: Thank you, Steve.