

# The Economic Stimulus and Sustained Economic Growth

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Oral Testimony  
to the  
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Thank you for the opportunity to speak with you about the current economic situation and the appropriate policy response. I look forward to your questions after my brief statement.

The current financial crisis and economic downturn are the worst that I have experienced. I believe this will be a longer and more damaging recession than any since the depression of the 1930s.

This downturn is very different from previous recessions. Past recessions occurred after the Federal Reserve raised the short-term interest rate in order to counter rising inflation. When it felt that it had succeeded, the Fed reversed direction and lowered rates. The lower rates then caused an economic recovery, primarily by stimulating housing construction.

The current recession was not caused by Federal Reserve tightening and the Fed has therefore not been able to revive the economy by lowering rates. Because of the dysfunctional credit markets and the collapse of housing demand, monetary policy has had no traction.

Stopping the decline of the economy and returning to sustainable growth will require two different kinds of policies:

- a policy to fix the housing problem that is the fundamental cause of the financial crisis, so that normal flows of private lending will resume
- a fiscal stimulus of reduced taxes and increased government spending to bring back aggregate demand

Today one out of every four mortgages exceeds the value of the home, giving the homeowner an incentive to default. As house prices fall, that incentive gets stronger. The fear of those defaults and of the resulting downward spiral of house prices means that financial institutions cannot have confidence in the solvency of other financial institutions and even in the value of their own balance sheet. That lack of confidence stops the lending needed for a return to sustainable growth.

Some months ago I proposed a policy based on Mortgage Replacement Loans that would allow house prices to continue the necessary adjustment to the pre-bubble level without triggering a rise in defaults and foreclosures. I have explained in my longer statement for this hearing how this would work. It would require a one-time expenditure of about \$150 billion that could come from the TARP funds.

The other proposals to help individual homeowners who are having difficulty meeting their mortgage payments would not go far enough to end the uncertainty about future mortgage defaults that prevents the recovery of the credit markets.

But while fixing the credit markets is necessary for sustained economic growth, it will not bring the economy back to full employment. Because monetary policy is not effective, reviving the economy requires a major fiscal stimulus from tax cuts and increased government spending.

It pains me to say that because I am a fiscal conservative who dislikes budget deficits and increases in government spending. Budget deficits and the resulting increase in the national debt impose burdens on future generations who will, as a result, face higher tax rates that will then weaken the future performance of the economy.

But while accepting that a fiscal stimulus is necessary in the current circumstances, it is important to design the tax cuts and the spending changes in the most cost-effective way.

Experience has taught us that one-time tax rebates are a bad idea because they raise consumer spending very little per dollar of deficit. So income tax changes should be permanent.

Tax cuts that strengthen marginal incentives are better than tax cuts that just raise after tax income. A permanent reduction in the income tax equal to about 20 percent of an individual's payroll tax payments would strengthen incentives and raise long-term employment by more than an equal cost \$500 per employee fixed tax cut.

Postponing the rise in personal tax rates on dividends and capital gains for five years would increase share prices, thereby raising consumer spending and business investment. Postponing the scheduled rise in the tax rate on high income taxpayers would raise consumer spending now.

A lower effective corporate tax rate would encourage more investment and employment in the United States.

The plan to raise spending by some \$200 billion a year, an amount equal to about 40 percent of nondefense discretionary spending, runs the serious danger of wasteful spending. To the extent that it is possible, the choice of outlays should be governed by the following four principles:

- First, they should raise demand for output and employment quickly in 2009 and 2010 with only a short tail into later years.
- Second, there should be an exit strategy. The spending should not create a political dynamic that makes it hard to stop
- Third, the spending should produce benefits beyond just creating jobs or should produce things that would otherwise have to be produced in a later year.
- And fourth, the spending should create favorable incentives and avoid unfavorable incentives effects.

As you know, President-elect Obama has identified five priority areas for increased spending: health, energy, education, infrastructure, and support for the poor. Although these important areas can benefit from increased spending, there are other parts of the budget that could also be useful as part of the stimulus package.

Since the defense budget is as large as all of the other discretionary spending combined, it is surprising that defense is not proposed as a part of the overall stimulus package. It is surprising also to read in the press that there will be reductions in military spending because of the weakness of the economy. That logic is exactly backwards. The overall weakness of demand in the economy implies that the next two years are a time when military spending along with other government spending should rise.

The actions of the military in Iraq and Afghanistan have depleted supplies and increased the wear and tear on

equipment. Both supplies and equipment will eventually need to be replaced. Now is the right time to do that.

Military recruiting and training could be expanded in response to the larger than usual numbers of unemployed young men and women. It would also be possible to depart from the military's traditional enlistment rules and bring in recruits for a short two-year period of training followed by a return to the civilian economy. This would provide education in a variety of technical skills that would lead to better civilian careers for this group. It would also provide a larger reserve force that could be called upon if needed by the military in the future.

The intelligence community and the FBI are also apparently facing potential budget cuts at a time of increasing terrorism and greater crime rates. A temporary increase in funding for these agencies could fill important gaps in training and facilities.

Another important omission in the current stimulus plan is funding for research. Government spending for research is projected to fall in 2009 even though additional research grants from the NIH and NSF could allow universities and hospitals to expand a wide range of useful research activities that are now unfunded because of limited grant budgets.

There are other important areas of government spending in which outlays can be raised rapidly on useful activities that would also raise incomes and employment. In each area, government budgeting must go beyond business as usual if it is to respond appropriately to the need for a short-term spending surge.

