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# Fiscal Policy in Deep Recessions

The current US recession, which will likely be the most severe downturn since the Great Depression, raises important questions for government spending and tax policy at state and federal levels. Should Oregon balance the budget through spending cuts or tax increases? Should the federal government reduce the budget deficit? Will the recent fiscal stimulus be successful in stabilizing the economy and stimulating recovery? And why didn't economists forecast the current recession?

Let's begin with the last question. The business cycle, with expansions occasionally interrupted by recessions, is an enduring feature of market economies. Asset price bubbles and crashes also appear to be intrinsic to markets. It is important to recognize that recessions are usually unpredictable. In general, the events that trigger recessions cannot be reliably predicted using either large-scale models, statistical methods or the judgment of seasoned professional economists. The current recession, triggered by the financial crisis and the stock market decline, is no exception. Although several prominent economists warned of impending trouble, the gigantic scale of the problems was a surprise to most economists, because the worst excesses were taking place using new financial instruments in a largely unregulated and hence essentially unmonitored sector.  Most recessions are a surprise, resulting from large shocks that could not be offset in time by policy.

Economists do, however, have a set of policies to avoid or minimize the impact of recessions and to promote recovery. The standard policy tools for dealing with recessions are two-fold: (i) easing monetary policy by reducing interest rates, and (ii) allowing normal fiscal "stabilizers" to work: in recession tax collections naturally decline and unemployment benefits and welfare payments naturally increase. At the federal level this can and should be financed by temporary increases in deficits. In contrast, state and local governments are typically required to balance their budgets, which is counterproductive in recession. The best way for states to deal with this issue is a reserve or "rainy day" fund, built up during boom times to finance the fiscal short-fall during recession. At the federal level the basic principles are to approximately balance the budget on average over the business cycle (a small average deficit is acceptable because of GDP growth), allowing deficits to rise during recessions.

When a recession is very large, as now, the usual anti-recessionary policies are insufficient, and aggressive fiscal policies are needed. When recessions are accompanied by a financial crisis, as now, special interventions are required to prevent a complete financial melt-down and ensure that credit remains available. Regulatory reforms are also needed, aiming to prevent similar financial crises in the future. Experience has shown that recessions precipitated by financial crises are usually longer and deeper than typical recessions.

The reason why aggressive fiscal policies are essential – temporary increases in government spending as in the current stimulus – is that the adverse shock has been so large that monetary policy is inadequate: cutting short-term interest rates to zero is not enough to ensure recovery. Without sizable fiscal stimulus there is the possibility of a destabilizing spiral of deflation and falling output.

The combination of aggressive monetary easing and sufficiently aggressive fiscal stimulus should be enough to stabilize the economy and eventually lead to recovery. This recovery will raise tax

revenues and, with appropriate long-term fiscal planning, debt levels relative to GDP will gradually return to normal levels. As the recovery begins, the monetary authorities will start to unwind current policy, increasing interest rates and reducing the total stock of money to prevent inflation from becoming a problem.

It is possible that yet more fiscal stimulus will be needed at the federal level. If so, additional stimulus should avoid across-the-board temporary reductions in personal income taxes, since these have small aggregate demand effects. More effective are temporary increases in government spending, on "shovel ready" projects, and additional funding to states and localities to increase or prevent reductions to their spending on services. Temporary investment tax credits to firms can also be effective in inducing firms to reschedule to earlier their spending on structures and equipment.

We must avoid retreating to the economics of Herbert Hoover. The argument that government should behave like families in recessions, reducing spending because times are hard, is misguided, because the proximate cause of current high levels of unemployment and low levels of GDP is a collapse of the aggregate demand for goods and services by households and firms. This is a Keynesian moment in history, and in this situation, temporary increases in government spending lead to higher incomes and more jobs. Households may anticipate higher future taxes to pay for the deficit spending, but the net effect on GDP and incomes is positive and substantial, and this prevents a dangerous slide into deflation. If the government spending is on infrastructure, broadly construed, then this also lays the foundation for a more productive recovery.

Is the current federal stimulus program sufficient? There is no simple answer. Policy affects the economy after a delay that is long, variable and uncertain. For monetary policy the main impact on GDP is usually one to two years after interest rates are reduced. The most recent monetary stimulus occurred in fall 2008. While for fiscal policy political delays are often a problem, "shovel ready" government spending projects can have an immediate impact. The February 2009 stimulus included $727 billion of spending and tax cuts spread over two years. As with monetary policy, there are subsequent indirect expansionary impacts on business and consumer spending. The lags and uncertainties make policy difficult. Too great a stimulus can lead to inflation if it impacts after the economy is expanding rapidly, but with too little stimulus the economy may fail to stabilize and recover.

In this situation the guiding principles are as follows. First, the biggest risk is a 1930s type depression triggered by a negative feedback loop of deflation, high "real" interest rates after correcting for deflation, and reduced private sector spending. We appear to have avoided this outcome, but if the overall price level begins to fall, this would be a signal that more action is needed. Second, policy needs to be continually revisited. The Federal Reserve Open Market Committee meets every six weeks to review monetary policy. US fiscal policy should also be reviewed frequently. The next several months may indicate the start of recovery or they may suggest that further action is needed. Finally, we also need a long-term plan to ensure that, after the recovery is underway, total publicly held federal debt will eventually return to its normal range of, say, 30% to 70% of GDP.

For Oregon there are difficult choices because the rainy day fund is too small. The best plan would have been to already have in place a larger fund to draw upon. I hope we draw the appropriate lesson for the future. Next best is to balance the state budget by temporary increases in taxes or, somewhat less good, by a mixture of temporary and permanent tax increases. The worst choice would be to cut government spending in line with the currently reduced tax revenues: that would intensify the recession in Oregon.

Although reasonable people can disagree on the appropriate role and size of government spending, we can agree that spending should be as productive as possible and that tax rates should be set to finance this spending on average. However, whatever the choice of overall level, there is a strong macroeconomic case for maintaining government spending during recessions and for temporary increases in government expenditures in deep recessions.

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